THE TRAGEDY OF THE POUND

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BY

PAUL EINZIG

Author of "International Gold Movements"
"The World Economic Crisis," etc.

SRINAGAR

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To

MY WIFE

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PREFACE

THE suspension of the gold standard in Great Britain opened a lively controversy as to the responsibility for the failure of the efforts to maintain the stability of sterling. Those in charge of the official monetary policy during this critical period have been subject to sharp criticism at home and abroad for having been unable to foresee the crisis and for having been unable adequately to cope with the emergency. On the other hand, the apologists for the official monetary policy seek to exonerate the authorities of all blame, and maintain that Great Britain has been the victim of circumstances over which she had no control.

The truth—if there is such a thing in the domains of currency controversy—lies somewhere between the two extremes. The endeavours to save the pound were doomed, as, for years before its collapse on September 21, 1931, powerful fundamental factors had been working against its stability. The defenders of British monetary policy are right in claiming that its failure was not due to any individual mistakes. Although, it must be admitted errors have certainly been committed, it was not these errors but the fundamental adverse factors that had sealed the fate of sterling. On the other

hand, these adverse factors were, to a great extent, the outcome of Great Britain's political and economic decline after the war, and, to that extent, the nation is responsible for the events of September 1931, though they were perhaps precipitated by mistakes made by the monetary authorities. At the same time, international factors, such as the monetary policy of other countries—more particularly France—and the accumulation of liquid international indebtedness, must bear the major part of the responsibility for the crisis.

It is the author's contention that, regrettable as the collapse of the pound may be, on balance it is likely to benefit both Great Britain and the rest of the world. Its beneficial effect upon Great Britain was to some extent instantaneous and obvious, though it may take some time before it manifests itself to its full extent. Its international beneficial effect is more obscure, especially as its immediate consequences tended to aggravate the situation, and conceivably the advantages may be counteracted for some time by conflicting currents.

The policy pursued by France since 1926 has been largely responsible for the situation which resulted in the suspension of the gold standard in Great Britain. The responsibility of France in this respect constitutes the main thesis of the author's recently published book, *Behind the Scenes of Inter-*

national Finance. In the present book this contention is upheld in its entirety, and in many ways it is even amplified, but the influence of French policy is co-ordinated with the other factors of importance which contributed to the collapse of sterling. The admission that the suspension of the gold standard in Great Britain is likely to prove beneficial may seem to be inconsistent with the author's critical attitude toward the French policy in his previous book. There is, however, in reality no contradiction. The deadlock, which may possibly be brought nearer to its close as a result of Great Britain's departure from the gold standard, would not have come about but for the policy pursued by France, and it is the French policy of deflation adopted in October 1931 that threatens to jeopardize the beneficial results of the change.

Whether or not the suspension of the gold standard is allowed to produce its favourable effect upon the international situation, it has certainly fulfilled a highly beneficial task in the domestic sphere. It has provided a timely warning of this country's declining strength, and may prove to be a turning-point in the post-war history of Great Britain.

20, BISHOPSGATE,
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December 1931.

P. E.

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CHAPTER I

INTRODUCTORY

In a few hundred years' time, when the economic affairs of the world will presumably be regulated by international Five Year Plans, the twentieth century will be regarded as a highly romantic epoch. Amidst the dull regularity of a well-planned economic system, our troubles, struggles and crises will be looked back upon in the same way as we look back upon the romantic glamour of the Age of Chivalry. An economic crisis, however sordid it may appear to those who have experienced it, will be regarded as a thrilling adventure by a generation to which economic crises will be only known through historical text-books. In a world with a perfectly organized economic system, accounts of the struggle in 1931 for the stability of sterling will read like an epic

of days gone by; and those who study the history of the failure of the desperate efforts to save the pound will be stirred by it just as we are stirred by a tragedy of Sophocles.

Indeed the history of the great collapse of September 21, 1931, contains the basic elements of a classical tragedy: the character of the hero is noble and magnificent, and his aims and endeavours are just; and yet his fall is fated, because his endeavours are in conflict with the world trend, and his collapse is necessary to satisfy supreme interests. The pound sterling has been for two centuries the symbol of stability and commercial integrity. It has been one of the pillars on which British prestige has been built up. In a world of turmoil it has been the fixed point which has provided a basis for consolidation. And yet it had to fall from the pedestal which it occupied with pride and dignity. It had to fall though the inevitable conflict of this stability with powerful and irresistible world tendencies.

The present generation is too much concerned with the prosaic details of the situation that has arisen from the suspension of the gold standard in Great Britain to appreciate its deeper significance. Amidst the everyday problems of its effect upon prices, foreign exchange, overseas investments, and last but not least, politics, the romantic

halo that surrounds the tragic defeat is hardly visible to us. But the Tancreds of what we consider the romantic age of the Crusades had also to grapple with the inconveniences, big and small, of common life, and did not perhaps realize that some centuries hence, when these petty annoyances were forgotten, their life would be regarded as one continuous drama. Though Carlyle reminded us that Charlemagne and Roland were after all human beings, with all the prosaic problems that this status implies, he did not succeed in dispelling the romantic aura that surrounds them in the eyes of a generation which has grown up amidst the sober atmosphere of modern civilization. Nor will the unromantic details of the struggle for the pound diminish the magnificence of the tragedy in the eyes of a generation whose life will be regulated like clockwork, and whose problems will have been solved for them in advance by rules which will have little scope for crisis, tragedy or romance. Possibly, amidst the monotony of an uninterrupted increase in physical welfare, they may even envy us the thrills of our crises, just as we are sometimes inclined to envy the mediæval knights-errant, in spite of our knowledge that they lacked most of the comforts and amenities which we regard to-day as indispensable. The desperate struggle of sterling to resist the currents which

undermined its stability will indeed be regarded as one of the most thrilling chapters in financial history. Although the student of future centuries will know the outcome of the struggle, he will nevertheless read the successive phases of the fight in breathless suspense, just as we read of the death-struggle of some hero of past centuries, hoping against hope that he may after all escape his fate. We know that Siegfried has to meet his destiny at Hagen's hands, and that his fall is necessary for the doom of the gods of the Valhalla, which is to open the way for a better era; and yet we cannot help sympathizing with the hero and hoping against our better knowledge that he may after all survive and emerge victorious. Even those of us who had realized that the fate of sterling was sealed, and that its fall was not only inevitable but necessary, were hoping all the time that, after all, some miracle might save it. With the characteristic inconsistency of human nature we welcomed every temporary respite, although it was obvious that it would make no difference to the final issue.

The collapse of sterling is attributed to a variety of causes: the advent of the world crisis which immobilized British external investments, the tyranny of Trade Unions which prevented an adjustment of wages, the financial policy of French

statesmen which weakened London's resisting capacity, and so forth. But all those who directly or indirectly contributed to the event of September 1931, whether Trade Union officials or bankers, politicians or speculators, were merely tools in the hands of Fate, executing instruments of fundamental tendencies. It was not only inevitable but—incredible as it may sound—in accordance with the interest of Great Britain as well as the world as a whole that the resistance of sterling to the destructive tendencies should break down. The stability of sterling has rendered in the past immense services to the British Empire and to the progress of mankind, but the stage had been reached when these very interests demanded that this rigid stability should cease. Therein lies the tragedy of the pound.

But for the collapse of sterling the British Empire would have most probably continued its post-war decline, and might have shared the fate of the empires of past generations, which collapsed or declined through the inevitable effect of the accumulation of wealth upon human nature. History repeats itself. It is impossible to say whether the British Empire would have followed the example of the Roman Empire with its spectacular collapse, or that of the Spanish Empire with its decline into political and economic insignificance, had

not the collapse of sterling provided a timely warning.

The reason why modern empires stand a better chance of resisting the influences which proved fatal to empires of past centuries is that, with the development of the modern financial system, a safety valve has been created through which the excessive wealth may vanish before it has succeeded in undermining the character of the nation. This safety valve is the modern currency system. When a nation shows signs of slackening and decline, the result is an adverse trend of its currency; this trend may be resisted for a prolonged period, but it necessitates the using up of a great part of the national resources. If the resistance collapses, the depreciation of the currency reduces the surplus wealth and compels the nation to resume hard work. In theory the result is the same whether or not the exchange resists the adverse trend. In practice, however, there is a considerable difference according to whether the liquidation of the surplus wealth is slow and gradual or sudden and dramatic. In the former case it may take a long time before the nation realizes the danger, and meanwhile the process of decline may continue. In the latter case, the shock of the collapse of the currency may awaken the nation from its apathy, and may arouse it to action to check the decay before it is

too late. Much depends upon the qualities of the national character. While for some nations the loss of resources through the safety valve of the currency may have to assume considerable dimensions, in the case of Great Britain the mere fact of the departure from gold appears to have been sufficient to produce the desired effect. The heroic fiscal sacrifices to which the nation submits without a murmur, the result of the General Election, the extension of the movement to support national production, the wages cuts and other measures of economy in industry and trade, are symptoms which indicate that, from a national point of view, the sacrifice of the stability of sterling will bear its fruits.

From an international point of view the part played by the fall of sterling is equally important. We shall endeavour to prove that, while its immediate effect was to aggravate the world crisis, in the long run it is likely to render a service to mankind. It was a first step towards the termination of the tyranny of gold. There has been since the war a strong movement towards the universal adoption of the gold standard. Once adopted, Government and public opinion in most countries considered its maintenance at all cost their supreme national duty, and to that end many nations were prepared to sacrifice industrial pros-

perity and financial or political independence. The result of this dogmatism was bound to be a prolonged state of industrial depression, as the volume of gold available was inadequate to meet requirements, and the excessive political and financial power of the principal holders of gold became a menace to international equilibrium. The suspension of the gold standard by Great Britain has broken the spell. The principle implied in the gesture of abandoning the stability of sterling is of immense importance, as it may lead to the evolution of a new conception of the gold standard in which the stability of a currency may be regarded as a means to an end, and not the end itself.

CHAPTER II

FUNDAMENTAL CAUSES

IN examining the causes of the depreciation of sterling, it is necessary to discriminate between fundamental and direct causes. The right way to approach the subject is to begin with fundamental factors, as chronologically they preceded the direct factors, and logically they were largely the cause of the latter.

The direct cause of the suspension of the gold standard was the wave of distrust brought about by the Central European banking crisis. There were, however, several fundamental factors at work which had tended to undermine the stability of sterling for some time past. Even without the acute crisis of 1931 these tendencies would have remained a more or less permanent source of inconvenience. The following are the most important of these fundamental causes of the fall of sterling :

(1) Discrepancy between the cost of production in Great Britain and foreign countries.
(2) Downward trend of world prices.

(3) Excessive taxation in Great Britain as compared with other countries.
(4) Gold hoarding by France and the United States.
(5) Abnormal international transfers of funds, especially through reparations and war debts.

(1) Even before the slump in prices during 1929–31, there was a considerable discrepancy between the cost of production in Great Britain and most of the rival countries. While wholesale prices in Great Britain and the United States were approximately on the same level, they were considerably lower in other industrial countries such as Germany, France, Belgium, Italy and Czechoslovakia. One of the causes of this discrepancy was the different policy pursued by various countries as to the rate at which their currencies were stabilized; but there were other contributary factors. Wages have been nowhere so inelastic since the war as in Great Britain. Although, generally speaking, the political power of Trades Unions has increased since the war in every country on the continent—with the exception of Italy—it has nowhere progressed to such an extent as it has in Great Britain. While in continental countries wages have been adjusted in accordance with economic requirements, in Great Britain their level has been determined largely by political considerations. The system of unemployment benefits has not developed in any

country to an extent approaching that in Great Britain. Another cause of the discrepancy in costs of production was the high level of direct taxation in Great Britain. In theory direct taxes are not supposed to raise the cost of production, their only effect being to reduce profits. In practice, however, if direct taxation exceeds certain limits it tends, directly or indirectly, to raise the cost of production. As industrial and commercial firms are not content to work at a nominal profit, in the long run high taxation tends to raise wholesale and retail prices, and handicaps the over-taxed country in international competition. Even if world prices had remained stable at the level of 1928, the discrepancy would have continued to exist, and would have placed Great Britain at a permanent disadvantage.

(2) The discrepancy between the cost of production in Great Britain and foreign countries has become accentuated as a result of the decline of world prices during 1929–31. It is true that the downward trend affected in the first place agriculture and mining products, and to that extent tended to reduce the cost of production of manufactures. But the depression in agricultural countries and the all-round decline of the purchasing power of consumers all over the world brought about also a decline of manufacture prices,

This was accompanied in a number of foreign countries by a reduction of wages. In Italy the reduction was carried out almost overnight by Government decree. In Germany negotiations between employers and employees were on the whole successful, thanks to the intermediary rôle played by the Government. In Great Britain, however, the Government in power during that critical period was pledged to support the apparent interests of employees against their employers, and there could be, therefore, no question of any official pressure in the interests of wage reduction. In certain isolated branches, such as the chemical industries, reductions were successfully carried out, but in the majority of cases the attempts to cut wages failed. Thus the level of wages, which after all constitutes the most important item in the cost of production, remained practically unchanged, while it declined in almost every other country. There was but little hope that in the long run this increased discrepancy could be eliminated either by a substantial recovery in world prices or by a substantial reduction of wages in Great Britain. Although it was obvious that this state of affairs would lead to the accentuation of trade depression and to an increase in unemployment, owing to the use and abuse of the system of the dole there was no hope that such considerations

would eventually induce the workmen or the Trades Unions to consent to wage reductions. There was no reason to anticipate any considerable recovery in the world price level. The factors which tended to bring about its fall were still in operation, and the most that could have been expected was that world prices would attain comparative stability in the vicinity of their pre-war level. As the process of wage reduction would have continued in all countries with the exception of Great Britain, the chances were that in the course of the next few years the discrepancy between the costs of production would have been further widened. This would have tended to increase the adverse balance of visible trade, and there was no hope whatsoever that this deficit could have been met by any corresponding increase in the invisible export surplus.

(3) We have seen above that the excessive level of direct taxation in Great Britain as compared with foreign countries was one of the reasons of the discrepancy between the cost of production in Great Britain and abroad. This was, however, by no means the only way by which high taxation tended to produce a permanent pressure upon sterling. Its direct influence in bringing about a steady outflow of capital was much more important than this indirect influence through its effects

on costs of production. In no country has direct taxation attained such proportions as in Great Britain after the war. Although in some countries the nominal percentage of direct taxation may have approached for awhile that of British direct taxation, in reality the actual burden remained considerably below that of British Income Tax, Super Tax and Death Duties, because the administration of direct taxes is nowhere nearly as efficient as in Great Britain. The extremely efficient organization of the British Inland Revenue Department, coupled with a high standard of fiscal honesty, reduces evasion to a comparatively small percentage. The discrepancy between direct taxation in Great Britain and abroad has widened to no slight extent as a result of reductions made by most other countries. In Great Britain, on the other hand, no substantial and lasting reductions could be made. The burden of public debt remained practically unchanged throughout the post-war period, and absorbed about three-eighths of the total budgetary resources. Other items of expenditure, far from declining, had a rising trend, largely on account of the increasing burden of the social services. Thus, while other countries reduced their expenditure and their direct taxation, British Income Tax remained all the time between four and five shillings in the pound. This, together

with the heavy surtax and the almost confiscatory death duties, was a too severe test for the fiscal honesty of any nation. While the predominant majority continued to bear the burden imposed upon them, the number of those who yielded to the temptation to evade these taxes by exporting their capital was increasing steadily. In many cases this evasion assumed the form of emigration. Many thousands of British subjects—" Britain's lost legions "—made France or some other country their permanent residence so as to avoid the payment of British taxes. Others again sent their securities abroad, and their dividends were collected on foreign account so as to evade the payment of income tax. Certain banks in Paris and other centres made a speciality of providing facilities for evasion, while the same object was also obtained by the establishment of a large number of holding companies, mostly in Switzerland, Lichtenstein and Luxembourg. Inasmuch as the flight from taxation assumed the form of a demand for foreign currencies, it represented a direct pressure upon sterling; inasmuch as British holdings of British securities were exported and assumed the disguise of foreign holdings, the dividends paid on these securities constituted a direct drain. If the securities exported were British holdings of foreign securities which henceforth assumed the

disguise of foreign holdings, to that extent the invisible export represented by the yield of foreign investments declined. In either case the movement brought about pressure upon sterling. There appeared no hope whatever for any narrowing of the discrepancy in taxation. The extent to which the operation of the sinking fund and conversion operations could have reduced the burden of the public debt in the lifetime of the present generation was negligible, while other expenditure items were either inelastic or tended to move in an upward direction. The pressure upon sterling brought about by high taxation was to be regarded, therefore, as permanent.

(4) The maldistribution of gold provided another factor tending to undermine the stability of sterling. Until about 1928 there was reason to hope that the surplus gold holding of the United States would gradually be redistributed as a result of the liberal foreign lending policy of New York bankers. After 1928, however, the Wall Street boom and the subsequent slump checked this form of lending activity, and this brought about a setback in the redistribution of the United States' gold surplus. At the same time France appeared on the scene as a buyer of gold. If countries with an export surplus available for lending abroad choose to repatriate this surplus rather than re-lend it, the

burden of the demand for gold is bound to fall upon countries with a free gold market who do not possess such a surplus. Even according to the optimistic figures of the Board of Trade, the British surplus available for lending abroad declined to some £39,000,000 in 1930. Owing to her obligation to finance the Empire, London was unable to stop overseas lending, and her overseas loans more than absorbed this small surplus. At the same time gold continued to pour into the United States, while France took every opportunity to increase her gold reserve. In the circumstances London had a difficult task to maintain her gold stock above her minimum requirements. Possibly, with the improvement of international conditions, lending abroad by the United States might have been resumed, and this might have provided a relief for London.

(5) Another permanent source of inconvenience which tended to undermine the stability of the pound was the abnormal scale of international transfers of funds. Reparations and war debts were the principal, but not the only, cause of these disturbing influences. It was obvious that the Young Plan did not provide a definite solution for reparations, and that the question of war debts would also have to be reopened sooner or later. The chances were that any suspension of repara-

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tions payments by Germany would be accompanied by a suspension of war debt payments by Great Britain's principal debtors. At the same time Great Britain was bound by honour to carry out the pledges to the United States irrespective of her receipts from her continental debtors. It was obvious that sooner or later this factor would have operated against sterling. Moreover, it was highly probable that the scaling down of reparations would not be a smooth process. A crisis comparable to the mark slump of 1923 was only a question of time. As Great Britain was one of the principal creditors of Germany, and financial crisis in Germany was bound to react unfavourably upon the position of London, the possibility of such a crisis had been vaguely apprehended, and constituted an adverse psychological factor. In addition to this psychological influence, actual transfers of funds on account of abnormal international indebtedness—whether political or commercial—tended also to work against sterling. Larger international transfers meant an increased strain upon London, which acted as the principal clearing house for such transfers.

CHAPTER III

RETURN TO PRE-WAR PARITY

THE deflationary monetary policy adopted by the British authorities after the war on the recommendations of the Cunliffe Report has been subject to a great deal of criticism, especially since the suspension of the gold standard. It is now generally recognized that it was a mistake to restore the pound to its pre-war parity. It is more than probable that, had those responsible for this policy possessed superhuman faculties of vision, they would never have embarked upon a deflationary campaign, and the pre-war parity of sterling would never have been restored. The question is whether, at the time when the return to pre-war parity was decided upon and carried out, it was reasonable to assume that sterling could be maintained at its old parity without unduly heavy sacrifices.

Before delivering a verdict upon the policy pursued by the British monetary authorities we shall have to consider the following points :

(1) Was it evident in 1925 that sterling at its pre-war parity would be overvalued as compared with its economic parity?

(2) Was there any reason to assume that, if sterling was overvalued, the discrepancy would not readjust itself by a corresponding reduction of British prices, cost of living and wages?

(3) Was there any reason to assume that any discrepancy that might arise would not be readjusted by a corresponding rise in prices abroad.

(4) Was there any reason to consider Great Britain's external reserve adequate to meet any strain that might arise during the transition period?

(5) Was there any reason to assume that with the problem of reparations and war debts unsettled, a crisis of the magnitude and violence of the present world crisis might arise? If so, was there any reason to suppose that it would endanger the stability of the pound?

(6) Was it reasonable to assume that with the pound at its pre-war parity, the burden of the public debt would not become too heavy?

(7) Was there any reason to assume that the advantages obtained through the restoration of the pre-war parity of sterling would more than outweigh the sacrifices involved?

(1) As to the first question, in 1925 it was difficult to foresee whether at its pre-war parity sterling would be overvalued as compared with its economic parity, i.e., the level at which a normal trade balance can be maintained. The United States was at that time the only important country on a gold basis, and her price level, therefore, was regarded as the world price level. The rate of 4·86 corresponded roughly to the economic parity

between Great Britain and the United States. In 1925 it was impossible to foresee the level at which other countries would stabilize their currencies. It is true that the currencies of several countries, such as Germany, Austria, Hungary and Czechoslovakia, were actually stabilized before 1925, and that their price levels were considerably below the British and American price levels; but in all these countries inflation had assumed such an advanced stage as to rule out the possibility of restoring the pre-war parity. It was by no means unreasonable to assume that a number of important industrial countries, such as France, Italy, Belgium, Japan, etc., would follow the British example and would restore their currencies to pre-war parity, in which case sterling would have been overvalued rather than undervalued as compared with some of the leading currencies. In 1925 it was rather uncertain whether or not sterling would be overvalued at its pre-war parity.

(2) Even if the British monetary authorities had foreseen that, as a result of the stabilization of a number of currencies at an unduly low level, sterling would become comparatively overvalued, the question arises whether they had reason to hope that this discrepancy could be eliminated within a reasonable time and without undue difficulties, either through an increase in the internal value

of the pound or through an increase in world prices. The possibility of raising the internal value of the pound depended almost exclusively upon the possibility of lowering wages. In this respect the outlook was anything but promising at the time of the return of sterling to its pre-war parity. The experience of the past five years has proved that it was practically impossible to obtain a substantial reduction of wages from the high level they attained during the post-war boom. Even during the first post-war slump, with unemployment rising rapidly, it was impossible to enforce wage cuts to any great extent. The establishment of the system of unemployment benefits practically stabilized wages, and the increased political power of Trades Unions made it impossible to enforce an all-round reduction. The number of strikes that occurred during 1921–5 had made it obvious that there was no reason to hope for any considerable results in that direction. When the British monetary authorities decided to restore the pre-war value of the pound, they must have been fully aware of this. If in spite of this, and in spite of the possibility of the pound being overvalued as compared with a certain number of currencies, they decided to take the risk, their decision was based upon either or both of the following assumptions: (*a*) That the world price level would sooner or

later adjust itself to the Anglo-American price level; (*b*) That Great Britain possessed adequate external resources to maintain the stability of sterling against any pressure that might arise during the transition period.

(3) It was by no means unreasonable to assume in 1925 that the adjustment of prices in industrial countries to the Anglo-American level was only a question of time. Had the world level remained at its 1925 figure for a number of years, the chances are that prices in most countries would have risen sooner or later to approximately the same level. The question is whether in 1925 it was justifiable to anticipate that the world price level would remain stable. There were at that time several economists who held the opinion that prices were likely to move in a downward direction for some time to come. This assumption was based mainly upon the fact that the world's gold supplies were inadequate to cover increased post-war requirements. A number of countries, in the first place the United States, had hoarded an unduly large proportion of the world's monetary gold supply. Apart from this, monetary requirements had increased enormously since the war. In most countries the note circulation had increased to a much greater proportion than the price level and required a much larger amount of gold cover. It is true that the

adoption of the gold exchange standard by a number of countries would have eased the situation, but, even allowing for that possibility, the chances were that gold supplies would be none too plentiful during the next few decades. At the same time, there was good reason to hope that the American surplus gold stock would gradually find its way to other countries. Thus, in 1925 it appeared by no means unreasonable to hope that a fall in world prices would not take place, and the assumption that wages and cost of production in other countries would rise to the British level was not unduly optimistic.

(4) As for the question whether there was any reason to assume that Great Britain's external reserves were adequate for supporting sterling during the transition period, the answer is decidedly in the affirmative. Although the gold reserves of the Bank of England were relatively small, and allowed but little margin for contingencies, Great Britain possessed a huge secondary reserve represented by her foreign investments amounting to some three and a half milliard pounds. During the war a considerable amount of British external investments was mobilized in order to maintain the stability of the exchange and to provide the Government with the necessary funds for paying for purchases abroad. Although in time of peace

such emergency measures were not envisaged, it was not unjustifiable to assume that in case of need the realization of certain foreign investments might provide the necessary relief. In the opinion of some, it was a mistake to leave this to chance. The question is whether there was any reason to assume that circumstances might arise when it would become impossible to realize any part of the external reserve.

(5) In 1925 international conditions were evidently far from normal. In spite of the adoption of the Dawes Plan it was obvious that the problem of reparations was far from being solved. It was highly probable that a definite solution through the scaling down of claims could only be attained through a series of crises, political and financial. At the same time there was no particular reason to assume that these crises would affect Great Britain's financial position to an unduly great extent. After all, the disastrous slump of the mark in 1923 affected the British position to a comparatively moderate extent only, and the likelihood of anything more severe than that crisis was negligible. Moreover, it was taken for granted that Great Britain could always depend on the wholehearted support of the United States. Nobody could claim to have foreseen the development of circumstances in the lifetime of the present genera-

tion which would prevent the United States from rendering assistance to Great Britain. In 1925 the financial power of the United States was at its zenith. In possession of a huge stock of gold and immense claims against the rest of the world, she controlled the financial destinies of all nations. Although history has proved that such one-sided development cannot be considered as permanent, there was absolutely no reason to suppose that the United States would suffer an eclipse in the sphere of international finance in the course of the next decade or two. Thus, apart from the inherent strength of Great Britain, the possibility of receiving support from the United States was in itself sufficient to justify the belief that conditions of extreme emergency would not arise during the transition period.

(6) Another question to be answered is: Was it reasonable to assume that in the long run Great Britain would be able to carry the immense burden of its internal debt of six and a half milliard pounds on the basis of the pre-war gold value of sterling? The answer to this question again largely depends upon the view one had to take as to the probable tendencies of the world price level. Assuming that prices remained more or less stable, or even that they might assume a rising tendency, it was a matter of opinion whether the burden of the

public debt might become unduly excessive. On the other hand, if the possibility of a decline of from 30 to 40 per cent. in world prices had been envisaged, then it ought to have been obvious that the burden of the public debt might become unbearable. Even on the assumption of a stable price level it required a great deal of optimism to believe that Great Britain could carry on with a dead-weight debt of seven and a half milliard gold pounds. It is true that what was regarded as an unbearable burden after the Napoleonic Wars has come to be regarded as an insignificant amount a hundred years later; but it may well be asked whether one had the right to assume that the twentieth century would witness an expansion of production and wealth comparable with that of the nineteenth. If so, the creation of real wealth would provide a *raison d'être* for the immense amount of fictitious capital created during the war. If not, the burden of the fictitious capital would necessarily prove excessive. The interests of producers would have to be sacrificed in order to feed this fictitious capital at their expense. By 1925 it ought to have been evident that a spectacular expansion, in a country which had reached such an advanced stage of development as Great Britain, could not reasonably be expected. At the same time, the possibility of the expansion of the

Colonial Empire might have provided justification for the optimism of those who believed that Great Britain was capable of carrying the burden of her public debt on the basis of the pre-war value of the pound.

(7) The restoration of sterling to its pre-war parity was obviously a leap in the dark. With so many unknown factors it involved a considerable amount of risk in addition to the inevitable sacrifices attached to a deflationary monetary policy. It was to be anticipated that industries would have to pay a heavy price for the return to the pre-war value of the pound; they would be at a disadvantage against their foreign rivals whose costs of production were lower; they would have to face the difficulties and losses of industrial disputes in inevitable attempts to reduce wages; they would have to bear the burden of heavy taxation necessitated by the huge public debt. Against this, what were the advantages which appeared to make it worth while to pay such a heavy price, and in addition to take a considerable risk? The principal material advantage attaching to the restoration of sterling to its pre-war value was the recovery of London's position as an international financial centre. To that end it appeared at that time indispensable that sterling should be raised to its pre-war parity. To-day everybody is

aware that a devaluation of sterling would not have prevented the recovery of London's position as a banking centre. The example of Paris duly proves this. In our highly realistic world it is not past records but the present position and future prospects that matter. Had sterling been stabilized at a lower level, the task of maintaining its stability would have been easier, and it would have inspired greater confidence. But in 1925 it was impossible to foresee this. The British authorities had every reason to take it for granted that a devaluation of sterling would have meant a definite abandonment of London's position as an international financial centre. Moral considerations were definitely in favour of the restoration of the pre-war parity of sterling irrespective of the sacrifices and the risks involved. It was in accordance with the British tradition of sound finance and commercial integrity. Although during and after the war the gold parity had to be abandoned under the force of abnormal circumstances, the world expected Great Britain to give an example by returning to parity at the earliest possible moment. To abandon the attempt to restore the pre-war value of the pound, before it was obvious that there was no chance of maintaining it, would have been a cowardly act, and Great Britain would have assumed grave moral responsibilities for its inter-

national financial consequences. Even though after six years of desperate efforts the attempt had to be abandoned, from a moral point of view the failure is less harmful to British prestige than would have been the lack of courage to attempt it.

CHAPTER IV

THE RATE OF STABILIZATION

ALTHOUGH several economists can claim to have foreseen that the revalorization of sterling to its pre-war parity would become the source of immense difficulties, none of them foresaw the principal cause that led to the failure of the efforts to maintain its stability. The opponents of the restoration of the pre-war gold standard did not anticipate, any more than the authorities responsible for that policy, that Great Britain would be confronted with a world-wide economic and financial crisis such as that of 1931. It would have required uncanny prophetic faculties to foresee in 1925 that in 1926 France would stabilize her currency in circumstances that would lead to a calamity without precedent. For it was the seeds sown by France in 1926 that brought the harvest of 1931. Even though admittedly there were powerful fundamental factors at work undermining the stability of sterling, the gold standard in Great Britain would certainly have survived, but for the world economic

crisis of 1931, caused largely by the French demand for gold since 1927. The fundamental cause of that demand was the stabilization of the franc at a low level, as a result of which prices in France were some 20 per cent below world prices.

The circumstances of the stabilization of the franc provide a characteristic example of the backward state of the development of international law in the financial sphere. It is the sovereign right of every country to manipulate its own currency at its will. The monetary policy of a country is considered its private affair, with which no outside interference could be tolerated. And yet, in our present economic system the monetary policy of a country tends to affect the monetary situation of other countries, and tends to influence, therefore, their prosperity. The process of the internationalization of finance has made enormous progress since the war. Innumerable new links have been established between various countries. The flow of capital between one centre and another has increased considerably in volume and frequency. As a result, the monetary policy of an important country tends to affect the situation in other countries to a much greater extent than before the war. Notwithstanding this, it has not occurred to anyone to contest the right of Governments to determine their monetary policy independently of other

Governments. While the respective rights of two nations which share a river or a lake are regulated by agreements based on the recognized principles of international law, there are no agreements to regulate the relations between the monetary policies of various Governments, and there are no recognized principles of international law upon which any such arrangements could be based; and yet, the interests involved in the use of a river, constituting the frontier between two countries, are negligible as compared with the interests involved in the regulation of monetary policies.

Since the war there has been a distinct tendency towards co-operation in monetary policy, and on several occasions central banks have been in communication with each other before they have changed their Bank rates. Gold withdrawals, transfers of funds, etc., have also been effected by national authorities in understanding with one another, but on questions of vital importance, such as the rate of stabilization of a currency, there has been no agreement or co-operation. In the case of smaller countries, which had to avail themselves of the assistance of the League of Nations in order to stabilize their currencies, the circumstances of the stabilization were determined in accordance with the wishes of the League Finance Committee, but in the case of countries which stabilized

their currencies independently of the League, the Government's decision was final. Thus, the British authorities acted independently when restoring sterling to its pre-war parity. Similarly, Signor Mussolini did not consult any other country when fixing the new level of the lira. The French Government acted also entirely independently of the rest of the world when stabilizing the franc. Possibly a future generation will regard this state of affairs as incomprehensible, but to our generation it seems entirely natural. A country is at liberty to stabilize its currency at the level at which this tends to discourage foreign imports, and tends to encourage national exports. If the same result were to be attained by raising customs barriers, and by subsidizing exports, there would be an outcry of protest abroad, and the Government's action would lead to a tariff war. If, however, the end is attained by the choice of a low rate of stabilization, no official objection is raised, and such criticism as may be directed against the policy of the Government is largely academic.

It is obvious that the stabilization of a currency at a low level carries advantages only if the number of countries adopting such a policy is small. If every nation were to reduce the gold value of its currency to the same extent, this would mean a uniform change in the world level of prices, and

none of the nations would benefit by it. If, however, one nation lowers the exchange value of its currency in relation to the others, it will enjoy the advantages of the lower exchange rate during the transition period, the length of which depends on a large number of circumstances. The reason why, in spite of this, there has not been so far a competition among nations to stabilize their currencies at the lowest possible level, lies in the serious disadvantages in the depreciation of currencies, and in considerations of prestige, for the sake of which most countries are prepared to forgo the benefits of a lower exchange.

Moral considerations have also played a certain part in the efforts of most Governments to stabilize their currencies at as high a level as they possibly can. The stabilization of a currency below its parity is beyond doubt the equivalent of a default. Circumstances have arisen in the history of every country which make such a default inevitable. So far as it is the consequence of conditions which the Governments of the countries concerned were unable to prevent, they can claim with right that they have acted in good faith. But if the rate at which the currencies are devaluated is chosen deliberately below the level at which the Governments concerned could have stabilized and maintained it, then they are responsible for a deliberate

default. To the extent to which the currency is below the level at which it could have been stabilized with success, the Government has deliberately reduced the liabilities of all debtors in its own currency, including those of the principal debtor, the Government itself. Such an act is bound to do immense damage to the moral standing of the country concerned.

It is, admittedly, very difficult to ascertain the level at which a currency can be stabilized successfully. The only reliable test is experience over a fairly long period. Any decision arrived at without adequate experience is bound to err either in the upward or the downward direction. The chances of guessing the right level are negligible. It is, nevertheless, possible to lay down some principles which should be followed in choosing the rate of stabilization:

(1) The exchange rate has to represent as nearly as possible the ratio between the world price level and the internal price level of the country concerned.
(2) An undervaluation of the currency, as compared with its theoretical parity, is justified if the country in question is not in a position to raise the resources required for maintaining the stability of the exchange at that rate.
(3) An overvaluation of the currency, as compared with its purchasing power parity, is justified if the country concerned possesses sufficient external reserves to maintain the stability of

the exchange during the transition period while internal prices adjust themselves to this new level.

It is a general habit to take wholesale prices as the basis for determining the so-called economic parity of a currency. Admittedly it is the level of wholesale prices that determines the trade balance of a country. If its wholesale prices are above the world level, this is bound to result in an unfavourable trade balance, while, if wholesale prices are below the world level, this is equally certain to improve the trade balance. But retail prices, the cost of living and the level of wages should not be disregarded when attempting to calculate the economic value of a currency. After all, wholesale prices are largely affected by transitory influences. If an exchange is stabilized at a rate which represents the parity between wholesale prices in two countries, it may or may not be undervalued according to whether this rate represents the ratio between retail prices and other items of the cost of living, and the ratio between the wages level, in the two countries. Retail prices, cost of living and wages are much slower in adjusting themselves to the changed external value of a currency than wholesale prices. Thus if the exchange is stabilized at a rate which represents the ratio between the cost of living or the wages-level in two countries,

then in the course of a comparatively short time wholesale prices will adjust themselves to the new level, and the exchange will then represent also the ratio between wholesale prices. The reverse, however, cannot be said to be true. If an exchange is stabilized at a rate representing the ratio between wholesale prices, it may take some years before retail prices, cost of living and wages adjust themselves to the new exchange rate. Thus a discrepancy between retail prices, cost of living and wages in both countries will continue to prevail and will affect the trade balance directly or indirectly.

There are circumstances in which it is justifiable and even desirable that a currency should be stabilized under its economic parity. If the country in question does not possess adequate gold and foreign exchange reserves, and is unable to secure such reserves by means of external long term borrowing, then it is desirable that the currency should be stabilized at a level which secures the accumulation of such reserves. Otherwise the currency cannot be regarded as safely stabilized. For, although in theory any currency can be kept stable at its economic parity, in practice it is necessary to reckon with abnormal factors working against its stability. If such factors are left out of account, the currency is left to the mercy of any temporary

adverse factor that may arise. Moreover, a slight undervaluation is justified on the ground of the difficulties of finding the economic parity of an exchange. There should be left a moderate margin to cover possible errors. Another much more important consideration is that of the burden of internal debt. A country with an excessive internal indebtedness should stabilize at a level which reduces the burden of its indebtedness to a bearable amount. If it attempts to stabilize its currency at a level which leaves the burden of the internal debt excessive, then in the long run it may be faced with budgetary and exchange difficulties which will make it difficult to maintain the stability of the currency at its new level.

A Government is justified in overvaluing its currency as compared with its economic parity if it possesses an ample margin of external reserves over and above the minimum requirements. The adjustment of wholesale and retail prices, cost of living and wages to the world level is merely a question of time. If a country can afford to lose a certain amount of its gold and foreign exchange reserves during the transition period while the adjustment of prices takes place, it is justified in fixing the new level of its currency above its economic parity.

The stabilization of a currency below the level

at which it can be maintained is an act of default as it secures advantages to the country concerned to the detriment of its creditors. While there is no moral obligation on the part of any country to overvalue its currency and thereby to sacrifice a great part of its external reserve, there is a strong moral obligation not to stabilize below the figure at which it could be maintained without abnormal sacrifices. Dishonesty is only profitable in a community where most people are honest. A dishonest man in a thoroughly dishonest community has no more chance of making exceptional profits than an honest man in an honest community. So long as most Governments endeavour to keep faith and stabilize at the highest possible level, the less scrupulous Government is at an advantage, and may reap the profits arising out of the stabilization of the currency at an unduly low level. But as soon as every Government, or at least the majority of them, realize that their honesty in a dishonest world places them at a disadvantage, they may be tempted to follow the bad example, in which case the stabilization of a currency at a low level would cease to be advantageous.

This state of things, however, has not yet been reached. After the war almost every Government attempted to stabilize at the highest level possible; in fact, if they erred in the choice of the rate of

stabilization, the error was in most cases in an upward direction. Thus Great Britain, the Scandinavian countries and a number of other countries stabilized their exchanges at their pre-war parity, which subsequently proved to be too high, and necessitated heavy sacrifices. Similarly, Italy chose her rate too high, not so much in relation to the world price level as in relation to the potential resources with which she could support the exchange. On the other hand, France and Belgium chose excessively low rates of stabilization. In the case of Belgium this was due to an error, made in perfectly good faith, through reaching a decision prematurely before conditions had settled down sufficiently to enable the authorities to form a judgment as to the level at which the exchange could be maintained. In the case of France, however, the choice of the rate of stabilization was the result of deliberate and mature consideration. While in the case of Belgium the period of pre-stabilization was very short, in the case of France it extended over 18 months, a long enough period to enable the French authorities to see that the level chosen was too low. Had the French Government stabilized the franc legally at the end of 1926 or early in 1927 its good faith in choosing an excessively low level would have been beyond doubt. The developments throughout 1927 and

during the first half of 1928 made it, however, plain that France could well afford to raise the franc to a higher level before stabilizing it legally. The trade balance showed a big export surplus, and the resources of the French authorities for maintaining the stability of the franc went on increasing on an unprecedented scale. By the spring of 1927 M. Poincaré must have realized that the economic level at which the stability of the franc could have been maintained without involving any actual sacrifices, was some 20 to 25 per cent. above the rate ruling in the pre-stabilization period. If in spite of that he maintained the franc at 124 and eventually stabilized it at that low level, it is because he realized the commercial, financial and political advantages of such a policy. While it is beyond doubt that the restoration of the franc to its pre-war parity would have been entirely out of the question, it is equally obvious that France could have afforded to stabilize the franc at a higher level, and to reduce the losses inflicted upon holders of francs and claims in terms of francs. Her position was that of a debtor who pays his creditors one-fifth of what is due to them although he could afford to pay one-quarter.

France could have well afforded to stabilize her exchange at or even above its economic parity. By the middle of 1927 it was evident that her gold

and foreign exchange reserves were amply sufficient to secure the stability of the franc. Although France had a huge internal debt, its reduction by three-quarters would have provided adequate relief. There was no need for reducing the whole of the internal debt to the extent of four-fifths.

It was this act of deliberate default on the part of France that was the main source of the difficulties which led to the international crisis of 1931, and which eventually compelled the British Government to abandon the gold standard. Had France stabilized her exchange at its normal level, her demand for gold during the following years would have been moderate, and would not have accentuated the maldistribution of gold. The decline of prices would either not have taken place at all, or would have been on a much more restricted scale. The economic depression following the Wall Street slump would have been in such circumstances much milder, and of shorter duration. The deadlock of 1931 would never have arisen, and the stability of sterling would not have been menaced.

CHAPTER V

INTERNATIONAL CAPITAL TRANSFERS

We have said in Chapter II that one of the fundamental causes that brought about the collapse of the gold standard in Great Britain was the abnormal increase of international capital transfers after the war. For a variety of reasons the volume of capital subject to transfer at short notice has become a multiple of its pre-war figure. This constituted a powerful factor jeopardizing international monetary stability. London, being the principal monetary centre, had to stand the major part of the strain.

The following are the most important causes of the abnormal increase of actual or potential international transfers after the war:

(1) Reparations and War debts.
(2) The services of the increased international commercial indebtedness.
(3) New foreign borrowing.
(4) Flight of capital on account of taxation or the uncertainty of the national currency.

(5) Internationalization of investment and Stock Exchange speculation.
(6) The practice of central banks and other banks of holding large balances abroad.

The disturbing effects of excessive reparations burdens upon the international monetary situation are too well known to require repetition. As the amount of annuities Germany had to undertake to pay was in excess of her capacity, she had to reborrow a substantial part of the amounts paid. These transactions resulted in frequent abnormal transfers on a large scale. The foreign commercial debts of many countries have increased as compared with their pre-war figures, and their service necessitated unusually heavy transfers. The destruction of capital through inflation in a number of countries was responsible for additional abnormal transfers. Countries with highly developed economic systems, such as Germany, had to replenish their working capital, which had been seriously impaired by inflation, and as they enjoyed excellent credit abroad, they were in a position to obtain large amounts of foreign capital. The fundamental change in the international distribution of wealth brought about by the war inevitably resulted in heavy international transfers to readjust the abnormal discrepancies.

The process of internationalization of finance

made immense progress in the post-war period. As a result of increased interest in, and better knowledge of, conditions abroad, investors were more willing to place part of their capital in foreign countries than before the war. On the one hand, wealthy countries such as the United States, Great Britain, Switzerland, etc., invested funds in countries which were in need of foreign capital. On the other hand, individual investors in borrowing countries considered it advisable to place part of their capital in safer countries. The distinction between lending and borrowing countries was merely one of degree, for every country became both a lender and a borrower on a large scale. Although the United States and Great Britain are the two largest creditor countries, at the same time they are among the largest debtor countries, for, apart from the huge amount of their short-term liabilities, the foreign holdings of British and American securities run into hundreds of millions of pounds. The knowledge that conditions have been less stable than before the war, and the desire to redistribute risk, may have largely contributed towards this situation, but one of its main causes has undoubtedly been the world-wide tendency to evade taxation, which has increased in every country since the war. The popularization of international speculative dealings has also provided

a source of abnormal international capital transfers. The extent to which foreign speculators took part in the Wall Street gamble in 1928 and 1929 was entirely without precedent.

The accumulation of foreign short-term balances in the leading financial centres provided another source of actual or potential transfers of capital. To a great extent this was a consequence of the other factors responsible for the increase in the volume of international transfers. Every bank considered it necessary to possess a larger volume of foreign balances than before the war. As a result of the adoption of the gold exchange standard in many countries, the foreign balances of central banks also increased to a great extent, while even central banks, which were not allowed by their statutes to include foreign currencies as part of their note cover, adopted the habit of keeping large foreign reserves. The large number of stabilization loans granted after the war also caused an increase in the volume of international short-term indebtedness, as the proceeds of loans of this character were for the most part left abroad, and this constituted a further potential source of international transfers.

As a result of these developments, the international money market lost its pre-war stability. It is true that between 1925 and 1931 outwardly

the situation appeared to be stable, but this apparent stability had no solid foundations. The excessive scale of international transfers provided a permanent unsettling factor, while the enormous extent of potential transfers hung, like Damocles' sword, over the international money market. Capital had become much more restless than before the war. It was ready to change its country for the slightest reason. The extent to which a country was able to draw upon other countries was abnormally great. As a result, practically every currency became extremely vulnerable. In order to safeguard it against any possible shocks that might be brought about by sudden capital withdrawals, it would have been necessary for every central bank to maintain a wide margin of gold reserves above its minimum requirement. Owing to the relative shortage of gold, however, this was impossible. While a small number of central banks were in a position to accumulate a big surplus, most central banks had to face the risks of operating with a comparatively narrow margin. An alternative solution would have been the establishment of genuine co-operation between central banks to assist each other in any difficulties caused by abnormal international transfers. While many central banks were prepared to co-operate to that end, the Bank of France was a notable

exception. Although it has always denied having aggravated the position by additional transfers on its own account, at the same time it has not made any effort to counteract the difficulties caused by transfers carried out by French banks.

It was the influence of this abnormal international short-term indebtedness which eventually brought about the collapse of sterling. As London was the leading international banking centre, she attracted substantial amounts of foreign balances, and a large part of the restless international capital assumed the form of foreign sterling deposits or holdings of sterling bills. In addition, considerable amounts of British Government bonds and other sterling securities were acquired by foreign investors. Thus, while Great Britain was lending on a large scale after the war, she became heavily indebted towards foreign countries, which had the power to draw upon London for very large amounts. It is true that the extent of Great Britain's indebtedness abroad was probably less than a quarter of the amount of her claims against foreign countries, but, while the predominant part of foreign claims against London was in the form of short-term claims, British investments abroad were mostly difficult to realize at a moment's notice even in normal conditions. London was thus exposed to sudden capital transfers amounting to three times

or four times the amount of the Bank of England's gold reserve. So long as confidence in London was maintained, there was nothing to fear, but as soon as confidence was shaken, abnormal capital transfers were in a position to break the stability of sterling.

CHAPTER VI

THE "GOLD STANDARD GAME"

It has become a commonplace in newspaper articles to say that the main reason why the gold standard in Great Britain had to be suspended was that other countries did not "play the game of the gold standard". Less colloquially expressed, this means that they did not abide by the rules of the gold standard as interpreted in the light of post-war experience. Many people who freely use these phrases, would be at a loss if called upon to explain what they mean exactly by the "game of the gold standard" and the "rules of the gold standard". When examining the relative importance of this factor amongst all those responsible for the suspension of the gold standard in Great Britain, it is, therefore, necessary to attempt to indicate these rules.

Before the war the rules of the gold standard were very simple indeed. The most important among them was to allow gold to go out whenever the exchange depreciated below its gold export

point. It is true that even before the war many countries on a gold basis did not abide by this rule. As is well known, almost every central bank had some device for discouraging gold exports whenever it did not suit their purpose. Thus, pressure was brought to bear upon banks to refrain from exporting gold when it would have been profitable for them to do so. In the case of the members of the Latin Monetary Union, the central banks often availed themselves of their option to pay out silver instead of gold. Another way of interfering with the free working of the gold standard was to encourage gold imports by artificial means. Many central banks were prepared to grant credits free of interest to importers of gold, while some of them even went so far as to pay a premium above the statutory buying price. The Bank of England was practically the only central bank which until 1914 "played the game of the gold standard" in the strictest possible sense. Every other central bank disregarded the unwritten rules on frequent occasions. In spite of this, comparatively little was said before the war about anyone not "playing the game". The system worked satisfactorily, and there was no reason for criticizing those who thought it necessary to interfere to some extent with normal tendencies. Although London was practically the only free gold

market, the burden imposed upon her by the disregard of the rules of the game by other centres was by no means excessive. In possession of the monopoly of the sale of newly produced South African gold, she could well afford to satisfy other requirements, even if they were not always entirely the result of the automatic working of the gold standard. These abnormal requirements were comparatively moderate. The establishment of the gold standard and the accumulation of gold reserves by most countries was spread over a period of about forty years, and the strain caused by purchases for that purpose was at no time excessive.

This state of affairs underwent a fundamental change after the war. The world's monetary requirements of gold increased to a multiple of the pre-war figure. This was due to the following reasons: Karl C. Bullard

(1) Until recently the price level remained considerably above the pre-war level.
(2) The note circulation in most countries increased to a far greater extent even than prices.
(3) The immense amount of fictitious wealth created since 1914 also increased the amount of gold backing necessary.
(4) The increased scale of international movements of funds compelled central banks to maintain a larger margin of gold above their statutory requirements than before the war.

(5) As a result of the demonetization of silver, the requirements of gold for monetary purposes increased.

(6) While before the war it was considered sufficient if the note circulation was covered up to a certain percentage by the gold reserve, after the war most central banks adopted the practice of providing note cover for sight liabilities also.

Against this, the withdrawal of coins from circulation by most countries increased the supply of gold available for central banks, while the adoption of the gold exchange standard by a number of countries reduced the demand. On balance, however, it is safe to say that the total monetary demand for gold was considerably higher than before the war. Moreover, while before the war the establishment of the gold standard by most countries was spread over a period of forty years after the war most countries established the gold standard between 1925 and 1930. In fact, the number of countries establishing the gold standard or the gold exchange standard during these five years was much greater than that of the countries establishing the gold standard before the war during fifty years. This was bound to result in a scramble for gold. Most central banks could not afford to wait until their gold stocks were replenished through the normal working of the system of the gold standard, and had to take the

initiative, directly or indirectly, in encouraging the influx of gold.

In the face of this increased demand, most holders of excessive gold stocks were reluctant to part with their surplus. The Bank of England resumed its traditional policy of not keeping more gold than was necessary for immediate requirements. Other central banks, however, accumulated huge surplus stocks during and after the war. Although the United States was willing to allow a moderate redistribution of its surplus, the suspension of lending abroad brought about by the Wall Street boom checked the process. The second largest holder of gold, France, aimed at increasing her holding, adding to no slight extent to the embarrassment of the world. Another large holder of gold, Spain, was most reluctant to part with any substantial amounts in spite of the fact that she was not on a gold basis, and her gold stock was, therefore, sterilized. Other big holders, such as Germany, the Argentine, Japan, Australia, etc., were eventually forced by necessity to part with a considerable amount of their holdings, but the gold thus released found its way directly or indirectly into the vaults of one of the two principal holders of gold, the United States and France. Thus, in face of the inadequate total supply, there was an excessive and urgent demand for gold, and the

situation was seriously aggravated by the maldistribution of the supplies available.

In such circumstances the pre-war rules of the gold standard could not be expected to hold good without substantial modifications. In the course of post-war practice it has become evident that the gold standard has to be interpreted in a different sense from that which was appropriate before the war. The changed interpretation of the gold standard has been recognized in the new statutes of a number of central banks, by the agreements concluded between various central banks, by decisions of the Board of the Bank for International Settlements, and by the recommendations of the Gold Committee of the League of Nations in 1930. Several of the new rules have remained, however, entirely unwritten, and some of them have been subject to controversy.

The following are the principal rules of the post-war gold standard:

(1) As the monetary authorities cannot afford the luxury of providing gold for internal circulation or for hoarding purposes, the issue of coins has been discontinued in most countries. The withdrawal of bar gold for hoarding purposes has also been discouraged officially or unofficially. In some cases the central banks have only been prepared to pay out gold for export for approved destinations, while in other cases the central banks have been given the right to call in any gold held internally.

(2) It has been recognized that in the changed circumstances the freedom of the gold markets cannot be applied in the same general sense as before the war. The principle has been adopted that monetary authorities should not take the initiative for withdrawing gold without the consent of the monetary authorities who would be affected by their action.

(3) In view of the increased requirements of the world, no country should withhold an unreasonably large amount by artificial means.

While the first of the rules has been observed by most countries, a number of central banks have offended against the second and third. Although technically they do not take the initiative for withdrawing gold against the wishes of other central banks, in practice they have had the means of encouraging a gold influx and also of discouraging any natural tendency that might lead to an efflux. The Bank of France has been undoubtedly the chief offender in this respect. By stabilizing the franc at an unduly low level, and by artificially preventing prices from adjusting themselves to the world level, the French authorities have created an artificial inflow of gold. Even though they have not taken the initiative in buying the gold, in practice the result has been substantially the same. Had normal economic tendencies been allowed to take their free course, the increase of the gold supply would soon have brought about an expansion of credit and a rise of prices which

would have automatically checked the inflow, and might have even led to an outflow. This, however, has been prevented by the French authorities, who adopted a policy aiming at the sterilization of the surplus gold.

The United States authorities have adopted from the very beginning the standpoint that the surplus accumulated during and after the war is essentially temporary, and should not be used, therefore, as a basis for credit expansion. In practice this well-meaning policy has resulted in the sterilization of a considerable part of the world's gold supply, and has probably been largely responsible for the declining tendency of world prices. In fact, the psychological influence of the existence of a huge gold surplus, which provided a basis for a potential expansion of credit, was probably largely responsible for the Wall Street boom, which again was the principal immediate cause of the international crisis. Thus gold hoarding by both France and the United States played an important part in bringing about the crisis. It would be, nevertheless, a mistake to criticize them indiscriminately, as the motive and the circumstances of the gold hoarding were fundamentally different in the two countries. The United States was anxious to rid herself of the gold surplus as soon as possible. France, on the other hand, deliberately pursued

her policy of accumulating gold. During the last few years the sources, from which the American gold stock was increased, were mostly outside Europe. A considerable amount of gold exported to Latin America during 1925–8 was re-imported during 1929–31, and, in addition, the United States received substantial amounts from Canada and the Far East. The increase in the French gold stock, on the other hand, was at the expense of other European central banks, especially the Bank of England and the Reichsbank. Thus, while the gold-hoarding by the United States had only a remote and indirect effect upon London's position, the policy of gold-hoarding adopted by France produced a considerable direct effect. London had to stand the burden of the accumulation of gold by France. Between June 1928, when France returned to the gold standard, and September 1931, when Great Britain suspended the gold standard, France imported about £136,000,000 of gold from Great Britain. This amount was roughly equivalent to the Bank of England's gold stock at the moment of the suspension. While the United States accumulated the greater part of its surplus many years before the beginning of the world crisis, the predominant part of the French withdrawals of gold took place either immediately before or during the crisis.

Had the United States and France released their surplus gold, either by means of lending abroad or by the adoption of a monetary policy which allowed natural economic tendencies to take their course, London would have been spared the pressure which eventually led to the suspension of the gold standard. The absence of adequate co-operation was largely responsible for the difficulties. Willingness on the part of the principal holders of gold to co-operate in a redistribution of gold would have gone a long way towards averting the world economic crisis, and would have certainly averted the suspension of the gold standard in Great Britain. While the United States has shown herself willing to co-operate, the French policy has been characterized by an extreme reluctance to be influenced by international considerations. The United States has done her utmost to "play the game of the gold standard", but was prevented from doing so by the Wall Street boom and the subsequent slump, over which her authorities had no control. France, on the other hand, has followed a policy of her own without any regard for the adverse effect of that policy upon the international economic situation.

CHAPTER VII

DIRECT CAUSES

As we have seen in the previous chapters, there were a number of fundamental tendencies at work to undermine the strength of sterling. In the present chapter we shall examine the immediate causes leading to its collapse. The most important of these was the economic crisis, as a result of which British overseas investments became largely immobilized. But for this circumstance the pound might, through the gradual realization of overseas investments, have withstood a prolonged strain. In normal conditions there would have been no need even to mobilize these investments. Lasting pressure on sterling would have necessitated the maintenance of a high bank rate, and this in turn would have resulted in the depreciation of securities with fixed interest. Foreign bonds issued in London would have become attractive to buy, and foreign dollar bonds placed in this country would have gradually been returned to the American market. At the same time the low price of British

Government securities would have stimulated foreign demand for them. Through the operation of these influences it would have been possible in normal conditions to withstand the strain even though it had lasted for many years.

The world crisis affected adversely the British trade balance. As a result of the unfavourable conditions prevailing in other parts of the world, British exports declined. British imports, on the other hand, were to a great extent inelastic owing to the existence of large unearned incomes which provided purchasing power irrespective of trade conditions. While in other countries consumption declined as a result of unemployment, in Great Britain the decline was comparatively moderate owing to the relatively high scale of unemployment benefits, social services, etc. At the same time the import of luxuries was kept up thanks to the distribution of over £300,000,000 per annum on account of the interest on public debt. Consequently the decline of imports lagged behind that of exports. Though, admittedly, the increase of the deficit of visible trade was moderate, invisible export items were affected to a much greater extent than commodity exports. Shipping suffered from the depression to a very great extent, and the idle tonnage of British ships reached record figures. The decline in the volume of international trade

affected insurance also, while British insurance companies suffered an additional handicap through their unwillingness to insert a gold clause in their policies. The demand for such a gold clause was increasing steadily throughout the first three quarters of 1931, and the attitude adopted by British companies resulted in a considerable loss of business. As for banking commissions on international business, they were negligible owing to the low rate of commission and to the standstill of international issuing business. Moreover they were wiped out by losses suffered through the failure of a large number of debtors. The yield on foreign investments, which is by far the most important invisible export item, declined considerably as a result of the depression, which affected most companies operating abroad. Dividends on rubber, tin, copper, etc., shares declined to a negligible figure. Later in the year the proceeds of overseas investments declined also as a result of the default of a number of South American Government debtors. In September 1931 the deficit on the trade balance, including invisible items, was estimated at about £100,000,000 per annum.

Had the strain upon sterling been caused solely by an adverse trade balance, it would have been possible to resist the pressure in spite of the im-

mobilization of overseas investments. After all, it would not have been difficult to raise £100,000,000 per annum; an adequate increase of the bank rate would have been in itself sufficient to counteract this unfavourable trend. But in addition to the pressure caused by the import surplus, there was a much stronger pressure caused by the wholesale withdrawal of capital. It began during the last quarter of 1930 when French banks reduced their London balances. Although this tendency was checked in January, it was resumed in July, and was the most important among the immediate causes of the suspension of the gold standard. The trouble began with the crisis of the Creditanstalt in May 1931, which was the first blow upon the hitherto implicit confidence in banks of international standing. The circumstances of the difficulties of the Creditanstalt were such as to inspire distrust of Central Europe, and American banks began to call in their credits from Austrian, Hungarian and German banks. London and other leading centres were compelled to follow their example. Although the Creditanstalt affair was temporarily settled in June, the settlement came too late to check the wave of distrust. It was hoped that President Hoover's gesture in suggesting a twelve months' debt moratorium might be sufficient to check the threatening crisis, but the

delay in its adoption by France reduced to a minimum its beneficial psychological effect. The withdrawals from Germany went on increasingly throughout June and during the first half of July. The credit of $100,000,000 given by a group of central banks to the Reichsbank proved to be a mere drop in the ocean, and failed to restore confidence. In July the failure of the Nordwolle and other commercial firms resulted in a run on several German banks, among others the Darmstädter-und Nationalbank. In order to avoid a crash the German Government imposed restrictions upon payments by banks, and as from July 13 credits granted to Germany were regarded as frozen.

It was a matter of common knowledge that British banks were heavily involved in German credits. Several leading acceptance houses were known to have committed themselves to a particularly great extent, and it was an open secret that the amount of their German credits exceeded their own resources several times over. This gave rise to fears abroad as to the solvency of these acceptance houses. Wild rumours were circulated concerning the alleged difficulties of firms whose names were regarded even a few weeks earlier as entirely above suspicion. Undoubtedly, difficulties would have occurred but for the readiness of the authorities to support any

London banking firm which found itself in a difficult position as a result of the crisis. In this respect the superiority of London as compared with any other banking centre manifested itself in a striking manner. Although London's difficulties were more severe than those of other leading financial centres, she was the only centre which had no bank failure throughout the crisis. It showed a remarkable example of solidarity. While in Paris and New York a number of second-rate banks were allowed to fail, in London everybody could rely upon help, if necessary. This fact has made the granting of actual support in most cases superfluous. Admittedly, the difference between the banking systems in Great Britain and other countries may have accounted to a great extent for the resisting capacity of British banks. The number of banks in London is comparatively small, and the doubtful elements were eliminated in 1929 when three small failures occurred. It may be safely said that almost without exception the London banking houses were, in the middle of 1931, in a sound position, and but for the German crisis they would have remained above suspicion. Thus, there was no need to fear that in granting support to any of them, the authorities would have been bolstering up inherently unsound positions.

The method adopted in assisting those in need of support was extremely skilful. In other financial centres, in every case where a bank had to be helped either by the authorities or by other banking interests, there was a great deal of publicity regarding their action. Even if no official announcement was made, it was a matter of general knowledge that the banks in question had to be assisted, and their standing was regarded as being no longer the same. In London, on the other hand, in the few cases where support was needed, it was arranged with a complete absence of publicity. In some cases there was no need even for the Bank of England to come directly to the rescue of the house which needed support. It was arranged that the clearing banks of the banking houses should simply increase their usual facilities as a matter of normal routine, presumably under the direct or indirect guarantee of the authorities. As a result, nobody except those directly concerned knew anything about the support given. The names of banking houses which had to be supported, and the extent of the total support, are only known to about half a dozen people who knew how to keep their secret. The policy of secrecy was not without its disadvantages. Although from the very beginning of the crisis it was understood that every banking firm of standing would be supported, no statement

to that effect was ever made. Had the authorities made a binding public statement in July, it would have gone a long way towards eliminating any fears as to the position of various acceptance houses. In the absence of such a statement, foreign banks lost confidence in a number of London banking houses and withdrew their deposits with them. In many cases foreign deposits were transferred from acceptance houses to clearing banks or to the Bank of England, but many foreign holders of sterling deposits preferred to withdraw their funds altogether from London.

An incident which characterizes the wave of distrust occurred towards the middle of July. The London branch of one of the French banks informed a bill broker that it did not wish to accept bank bills as security for loans, and asked him to replace these bills with treasury bills. This action caused a wave of indignation in London, and there was some talk of boycotting the French bank in question. In fact for a day or two most foreign exchange departments refused to take its name. Had a public statement been made as to the willingness of the authorities to support every banking firm of standing, such incidents might have been avoided. It is doubtful, however, whether such a declaration would have checked the outflow of foreign funds. The reason why foreign banks

withdrew their sterling balances was not so much their distrust of certain banking houses, as their distrust of the stability of sterling. This explains why most of them preferred to liquidate their sterling balances instead of merely transferring them from banking houses to clearing houses or the Bank of England, or instead of switching over from bank bills to treasury bills. Moreover, apart altogether from the question of confidence, considerable funds were withdrawn solely for the purpose of increasing the liquidity of foreign banks. It is true that when they had the alternative of withdrawing balances from London or from New York, they usually increased their liquidity by reducing their sterling balances.

The causes of the wave of distrust which brought about the heavy withdrawals of foreign balances may be summarized as follows:

(1) Fears as to the effect of the German crisis upon the British banking position.
(2) Inadequate gold reserves of the Bank of England.
(3) Unsatisfactory relations between British and French authorities.
(4) Distrust of the budgetary policy of the Labour Government.
(5) A pessimistic interpretation of the figures published by the Macmillan Report as to London's net foreign short-term liabilities.

As a result of the combined effect of these influences there was a wholesale withdrawal of funds

from London throughout the summer of 1931. It is this withdrawal rather than the deficit on the current trade balance that was the direct cause of the suspension of the gold standard in September. While it would have been easy to find adequate support to counteract the effects of the adverse trade balance, it was impossible to raise sufficiently large external credits to counteract the effect of this outflow of capital.

A highly controversial question is how far France was responsible for the withdrawal of funds which led to the crisis of the pound. It is understood that the authorities did not withdraw any balances throughout the crisis. On the other hand, the amount withdrawn by French banks is believed to have been very heavy. Until the last week of July the French authorities did nothing to check these withdrawals or to counteract their adverse effects. It may be said that it was the attitude of the French banks that determined the attitude of other continental banks, which followed the French lead. But for the wholesale withdrawal of French funds, the extent to which foreign funds would have been withdrawn would probably have been comparatively small.

CHAPTER VIII

ERRORS AND OMISSIONS

We have seen in the previous chapters that fundamental factors working against the stability of sterling made the suspension of the gold standard inevitable. No human being was able to foresee the development of such an unprecedented situation, and even if they had been able to foresee it, it is doubtful whether much could have been done to prevent it. For this reason the criticism directed against the British monetary authorities and banking interests for having failed to prevent the crisis is largely exaggerated. It is highly improbable that any of those who indulge in criticizing our monetary authorities could have done better had they been in a responsible position.

At the same time there is no doubt about it that errors and omissions were committed. Without being unduly critical, it is necessary and desirable that the criticisms raised should be examined and discussed, as it may provide a useful lesson for the future.

The following are the principal points of criticism raised in connection with the suspension of the gold standard previous to the beginning of the acute financial crisis :

(1) No timely provisions had been made to acquire an adequate margin of gold reserve.
(2) Interest rates had been kept too low.
(3) No steps had been taken to discourage excessive lending to Germany.
(4) No steps had been taken to obtain an adequate exchange of information.
(5) No provisions had been made to eliminate the danger of excessive French balances in London.
(6) No steps had been taken to discourage the use of finance bills.

While every other central bank aimed at increasing its margin of gold reserve above the minimum requirements to a high level, the Bank of England considered it superfluous to maintain a substantial margin. According to the Cunliffe Report, Great Britain's minimum requirements of gold should normally be £150,000,000. The gold reserve hardly ever exceeded this figure appreciably for any length of time, while during the last two years it was often below this limit. It was, of course, difficult for the Bank of England to maintain a large reserve in face of the adverse economic factors, and in face of the persistant French demand. It would have been impossible to increase the gold reserve by normal methods of monetary policy.

The only possible way would have been the timely arrangement of a substantial external long-term loan by the Government, the proceeds of which could have been kept in the form of dollars for emergency. Before the crisis became accentuated in June 1931 it would have been easy to arrange such a loan on favourable terms. All the leading financial centres would have welcomed a British Government issue, and in all the uncertainty of world conditions the investing public in most countries would have been eager to subscribe. But the idea of an external loan would have met with strong opposition in Parliament and in the Press. To increase the already unbearable burden of the public debt would have been a most unpopular measure. Even if the authorities realized the necessity for such a step—which is by no means certain—it would have been a difficult task to convince British public opinion that an external loan was necessary in order to safeguard sterling. In fact, possibly it would have been regarded as a sign of weakness, and would have produced an adverse psychological effect. The risk involved in this direction was not very great, however, before June 1931. Possibly our authorities were reluctant to give a bad example in increasing their gold reserve, but this objection might have been overcome by leaving the proceeds of the loan in New

York and in other leading foreign centres. Our authorities did not reckon with the possibility of such a wave of distrust as occurred during the summer of 1931. They assumed that London could afford to work with a smaller margin than other financial centres, in spite of the disturbing international factors which really made it necessary for an international banking centre to maintain a wide margin. Even if the authorities had increased their gold or foreign exchange reserve by the issue of a big external loan, it is doubtful whether the surplus would have remained in their possession for any length of time. Owing to the trade depression that prevailed in Great Britain ever since the war, there has been a strong movement in favour of keeping the Bank rate at the lowest possible level. Had the reserves of the Bank of England risen considerably above the minimum of £150,000,000, there would undoubtedly have been strong pressure brought to bear on the authorities to effect a reduction of the Bank rate, and the result would have been a decrease in the reserve through the withdrawal of foreign balances, and an increase of foreign borrowing.

The authorities have been criticized in some quarters for having maintained the Bank rate at a too low level since 1930. There is no doubt about it that inadequate remuneration was one of

the reasons why French balances in London were reduced. It is doubtful, however, whether it would have been beneficial in the long run to retain these balances with the aid of a high rate of interest. When the crisis became accentuated they would have been withdrawn in any case, and larger withdrawals would have further increased the difficulties of London, and would have accelerated the inevitable suspension of the gold standard. Possibly an increase in the Bank rate at the time of the Creditanstalt crisis might have resulted in the calling in of British credits to foreign countries, and to that extent it might have provided some support for sterling. But the importance of the influence of Bank rate in times of crisis should not be over-estimated. This whole question will be examined in detail in a later chapter.

A much more concrete charge against the authorities is that they omitted to discourage excessive lending to Germany. While it was too much to expect the man in the street, or even the average banker, to realize that the problem of reparations was bound to lead to a crisis sooner or later, the monetary authorities ought to have been aware of it, and ought to have used their influence to keep lending to Germany within reasonable limits. They must have been aware for years past that London had been placing too

many eggs in the same basket. No steps had been taken to discourage further lending, either by fixing a higher rediscount rate for German bills, as was done in France, or by declining to rediscount German bills financing trade between Germany and countries other than Great Britain, as was done in Switzerland, or by an extremely strict scrutiny of the nature of the bills, as was done in Holland. In fact, even without any of these measures the Bank of England would have been in a position to discourage lending to Germany by hinting at the dangers involved. As the market usually readily follows hints coming from official quarters, there is reason to believe that such a mild form of discouragement might have been sufficient.

In all fairness it ought to be admitted that our authorities were by no means alone in allowing excessive lending to Germany. The same criticism applies also to the American, Swiss and Dutch authorities. In fact, the total amount of lending to Germany was much greater in the United States than in Great Britain, while the proportion of German borrowing to total banking resources was much higher in Switzerland and even in Holland. The fact that the French authorities gave a timely warning to their banks by raising the rediscount rate on German bills to ½ per cent above the Bank

rate should not be regarded as a sign of their superior foresight. It was intended to be a political measure, and only incidentally happened to be beneficial to banking interests. Apart from France, the authorities in every country were shortsighted as far as the German position was concerned. It is hoped that the experience of 1931 will teach banks and monetary authorities a lesson, and that in future no bank and no banking centre will lend an excessive share of its resources to any one particular country.

One of the reasons why lending to Germany was allowed to assume excessive proportions was the absence of adequate information as to the total amounts involved. Banks and acceptance houses were tempted to increase their credits owing to the strong competition for acceptance business. While before the war London was practically the only acceptance market, since the war New York, Paris, Amsterdam and Switzerland have acquired part of the acceptance business done by London in pre-war days. Moreover, while before the war the acceptance houses practically monopolized all acceptance business, joint stock banks have taken an increasing interest in it. As there was no corresponding increase in the volume of good-class acceptance credits, everybody was anxious to retain as large a volume of apparently safe business

as possible. It was generally believed that the risk involved in granting acceptance credits to leading German banks was negligible. These banks were regarded as entirely above suspicion, and in any case it was taken for granted that the German Government would support them in case of trouble. For this reason, banks all over the world were prepared to grant them acceptance credits at an abnormally low rate of commission. Although it was a matter of general knowledge in London as in other centres that the volume of German bills represented an excessively large proportion of total bills, no figures were available to that effect. In 1929 attempts were made to arrange the pooling of information concerning foreign credits, but they failed. Some of the leading acceptance houses were unwilling to co-operate in the scheme, while joint stock banks kept entirely aloof from the movement. The authorities did not adequately support the scheme. Their insistence on the pooling of information might have been sufficient to induce those opposing it to modify their attitude. Failing that, they would have been in a position to induce the Government to pass the necessary legislation empowering the authorities to demand the information required for enabling them to appreciate London's position.

The first attempts at collecting information

regarding foreign credits and foreign balances were initiated by the Macmillan Committee. At the request of this Committee the Bank of England sent out circulars to banking houses requesting them to supply information as to their total foreign credits and total foreign deposits and bills. This was decidedly a step in the right direction, although it did not go far enough. Unfortunately the information thus collected was rather one-sided, as it did not include the amount of British deposits and balances abroad. As a result, the excess of London's short term foreign liabilities over her short-term foreign claims was shown to be even greater than it was in reality. As the publication of the Macmillan Report coincided with the German banking crisis, the disclosure of the figures must have largely contributed to aggravate the wave of distrust against sterling. The fact that foreign balances and foreign holdings of bills amounted to £407,000,000 in March 1931, against which British credits amounted to only £153,000,000, was regarded as a strong bear point against sterling, and probably contributed to accelerate withdrawals of foreign balances. Had the material been collected earlier, its publication would not have caused such a shock. In any case there was no need to publish the figures, which could have served merely for the guidance of the authorities.

The gradual accumulation of French balances in London throughout 1927 and 1928 was regarded with growing uneasiness. In spite of this, no steps whatever were taken to defend London against the potential danger of sudden withdrawals of French funds. In 1928 our authorities were well in a position to counteract any drain upon the gold reserve caused by a gradual withdrawal of French balances. If at that time they had discouraged London banks from giving these balances a favourable rate of interest, possibly the amount might have been reduced, though, of course, nothing could have prevented French interests from acquiring sterling bills in the open market. The position of the authorities was extremely difficult; had they lowered the Bank rate so as to drive out French deposits, the loss of gold caused by the pressure on sterling would have soon compelled them to raise their Bank rate. The only possible solution would have been the conclusion of an external long-term loan as suggested above. This would have led to a reduction of French balances, but it would have increased foreign borrowing in London.

Another point of criticism is that the authorities did not take sufficient care to discourage finance bills. It is believed that at least 75 per cent of the acceptance credits arranged for German banks

were used for drawing bills which were not self-liquidating. There is reason to believe that the long-term credits granted by German banks to exporters to Russia and other countries were financed by three months acceptance credits in the leading centres. Although the proportion of finance bills was smaller in London than in any other centre, it was by no means negligible. It was, of course, desirable to maintain in London a fairly substantial volume of acceptance business. After all, London's position as the leading international banking centre largely depended on the maintenance of an active discount market. Had the volume of bank bills been allowed to decline to a too low level, it would have been detrimental to the efficiency of the discount market, and would have placed London at a disadvantage against rival centres. In spite of this, the authorities and banking interests ought to have realized that, if they had to choose between a scarcity of bills and a flood of unsound bills, the latter must be the worse evil. The frequent warnings against the excessive use of finance bills published in the contemporary Press were of no avail; in fact, the joint stock banks, anxious to expand their acceptance business, reduced their commission on acceptance credits to the nominal figure of $\frac{1}{8}$ per cent for three months, which barely covered the clerical work involved, and allowed

little or nothing for the risk from bad debts. It is true that this exceptionally low rate was not generally adopted, and was only granted to banks of first-class standing, but it is just because of this that the reduction tended to encourage the use of finance bills. While the acceptance credits arranged directly for German and other foreign industrial and business firms were mostly used for drawing genuine self-liquidating bills, those arranged for German and other foreign banks largely served the purpose of mobilizing the frozen assets of those banks. If a German bank was unable to collect its claim against a German firm, it made arrangements that the firm in question should draw bills against an acceptance credit arranged for it under the guarantee of the bank in London or some other centre.

Those responsible for the reduction of the acceptance commission to ⅛ per cent sought to justify their attitude on the grounds that the risk involved in granting acceptance credits to first-class banks was practically nil. They maintained that, as local banks were in a better position to follow local conditions, it was to the advantage of the London market if acceptance credits were granted under the guarantee of those banks. Subsequent developments proved, however, that this theory was not altogether justified. While the acceptance

credits granted to German banks became definitely frozen after July 1931, many of the German business firms continued to meet their direct liabilities to London acceptance houses.

It is evident that several mistakes were made both by the authorities and by banking interests previous to the crisis. It is only fair to emphasize, however, that the same mistakes were committed in other countries to an even greater extent. The crisis of 1931 was entirely without precedent, and it is only natural that nobody was adequately prepared for it. Even if the authorities and banking interests had done their utmost to avoid these mistakes, London would have been seriously affected by the crisis, and the difference would have been merely one of degree. The status of London as an international banking centre placed her under a moral obligation to remain an active international banker at a time when this profession involved grave disadvantages and risks. Paris could well afford to withdraw from Germany in good time, as for her the rôle of international banker was a passing phase. If a market wishes to remain a permanent international banking centre, it has to play the game in good times as well as in bad. A banker who would lend freely during a boom, but would discontinue activities during lean years, would hardly be in a position

to acquire and retain a set of first-class permanent customers. Moreover, had London restricted her credits to Germany in 1928 or 1929, New York and other centres would have followed her lead, and this would have brought about a crisis. It is doubtful whether its repercussions on London would have been any less severe than in 1931.

CHAPTER IX

THE DEFENCE OF STERLING

In the previous chapter we dealt with the errors and omissions committed previous to the financial crisis. Let us now examine the steps that were taken after July 1931 in defence of sterling. If it was difficult to take any preventive measures against an unforeseen danger, it was even more difficult to do the right thing in the throes of the crisis. It would have been indeed impossible to expect any monetary expert to avoid committing errors in such a situation where neither past experience nor technical knowledge nor imagination were of much help. The psychological factor became of such predominant importance that the technical effects of any proposed measure as compared with its psychological effect was negligible, and no human being could possibly foresee the psychological reaction of any step or decision. Every decision was in reality a leap in the dark, and its consequences could not possibly be calculated. In such circumstances it would be unfair to adopt a too

critical attitude towards the mistakes that were undoubtedly made. It is easy to be wise after the event, and anyone who wished to find fault with the measures taken between July and September to defend the pound would have an easy task. But the events of those three months should be examined in a constructive and not in a critical spirit. As we said in the previous chapter, in discussing the errors and omissions of which the authorities were accused, our object is not to criticize but to provide material with the aid of which the occurrence of similar mistakes might possibly be avoided.

The following are the chief points of criticism raised against the measures taken in defence of sterling during the summer of 1931:

(1) The authorities ought to have realized already in July that the position of sterling was hopeless, and that any effort to prevent its fall would only cause the country's external credit to be used up to no purpose.

(2) The authorities ought to have realized that with a small short-term credit of £50,000,000 it was impossible to counteract the adverse factors working against sterling.

(3) In placing certain banks in charge of the operations in support of sterling, the authorities enabled the market to gauge the extent to which their resources were being consumed.

(4) After the first credit of £50,000,000 had been used up in less than three weeks, the authorities

ought to have realized that a second credit of £80,000,000 would meet with the same fate.

(5) Suggestions regarding the mobilization of foreign securities held in Great Britain were not taken up by the authorities.

(6) The tactics pursued in fixing the premium on forward dollars too low encouraged speculation against sterling.

(7) While the authorities pegged sterling against the dollar and the French franc, they left it unpegged against the Dutch guilder.

(8) The distrust against sterling was accentuated by the inopportune suspension of the delivery of sovereigns by the Bank of England.

(9) The Bank rate was too low throughout the crisis.

The moment the authorities realized that they could not obtain a large credit in the United States for the support of sterling, they ought to have been aware that there was little hope of maintaining the gold standard. It was evident that, in trying to bolster up sterling against irresistible tendencies, they were fighting a losing battle. The cost of the hopeless attempt to maintain the stability of sterling was the increase of Great Britain's liabilities in foreign currencies by £130,000,000. The actual loss on the operation can only be ascertained after the repayment of the French and American credits. Assuming that the dollars and francs have to be bought at an average premium of 30 per cent, the Treasury will lose some £40,000,000. In spite of this, there is much to be

said in favour of the attitude taken up by the authorities. Possibly they were fully aware of the hopelessness of their position, but were unwilling to give up sterling without putting up a desperate fight. To have abandoned the gold standard in July would have been regarded as an act unworthy of British traditions. So long as there was a possibility of obtaining external support it was the moral duty of the authorities to make use of the resources available, even if in doing so they were incurring losses. Had they suspended the gold standard in July instead of in September, the good faith of their attitude would have been open to doubt. As it was, it was obvious to everybody that Great Britain was swept off the gold standard by irresistible forces, after having done her utmost to postpone the inevitable at the cost of heavy sacrifices. The loss of prestige through giving up the gold standard without a fight would have been, in the long run, much more expensive than the action undertaken in its defence.

For this reason, the authorities did the right thing in attempting to support sterling. The details of the method of their support left, however, much to be desired. The fact that at the end of July they expected to stop the flight from the pound by the conclusion of a credit of £50,000,000 shows that they had under-estimated the danger.

According to the figures of the Macmillan Committee, London's foreign short-term debt was over £400,000,000. Against this, her realizable short-term foreign claims, after deducting German and other Central European frozen assets, were hardly more than £50,000,000. Thus there was a net short-term indebtedness of £350,000,000. In addition, large amounts of British Government bonds and other sterling securities were held abroad, and their proceeds could also be withdrawn at short notice. The amount of potential foreign withdrawals might be estimated, therefore, at something like £500,000,000. Apart from this, the possible amount of British capital that might be transferred abroad in anticipation of high taxation or a depreciation of sterling was almost unlimited. Against this avalanche, the authorities hoped to defend sterling with a short-term credit of £50,000,000 ; in fact, they appeared to have been under the impression that the mere conclusion of these credits would be sufficient to restore confidence and that the necessity for drawing upon them might not arise at all. This assumption might have been correct had the amount of the credit been at least £200,000,000 instead of £50,000,000. As it was, the illusions in respect of the magic power of the credit arrangements were shattered a few days after the conclusion

of the credit. For a fortnight or so, the Bank of France was supporting sterling on its own account. On August 5, however, it discontinued the support, and, as the British authorities had made no arrangements for the use of the credits, there was a sharp break in sterling and the exchanges moved considerably below gold export point. This showed that the mere conclusion of the Franco-American credit was not sufficient to eliminate fears for the prospects of sterling. The British authorities were compelled to draw upon their credits in order to restore sterling to within the gold points and to maintain its stability.

The official operations for the support of sterling against dollars were entrusted to the British Overseas Bank. Although this bank carried out its task with the utmost skill, it was inevitable that its activities should attract the attention of the market. As the volume of its foreign exchange operations was a multiple of its normal turnover, it soon became obvious to everybody that the bank must be acting on behalf of the authorities. The market soon realized that dollars were "on tap" at the British Overseas Bank, and the volume of its operations gave an idea of the extent to which the credits were drawn upon. At the same time the Anglo-International Bank

was put in charge of supporting sterling against French francs. As in normal times its operations in that currency were negligible, the market quickly realized that it was acting on behalf of the authorities, and that the extent of its operations indicated the extent to which the franc credits were being utilized. It was evidently a mistake to put two comparatively small banks in charge of the official operations. The Bank of England ought to have taken charge itself, and ought to have distributed its orders through several banks, both in London and in foreign centres. Unfortunately the Bank had neither experience in dealing with foreign exchange nor an adequately equipped foreign exchange department. A year or two before it had established a foreign exchange department solely with the object of carrying out the occasional operations of the Bank for International Settlements and of central banks for which it acted as agent. But this department was not adequately equipped to handle the support of sterling, and it would have been difficult to extend it at a moment's notice in a time of emergency. The alternative to this was to hand over the task to a number of leading banks, which would have rendered the operations less conspicuous. Towards the end of August the authorities resorted to this solution after the dis-

advantages of the experiment with the two banks had been realized.

Apart from the fact that official operations through medium-sized banks attracted too much attention, they had also another disadvantage. It is a general custom not to take the name of any bank for unlimited amounts of forward exchange transactions. Most banks have a limit for every name, however first-class it may be. Although it was generally known that both the British Overseas Bank and the Anglo-International Bank were acting on behalf of the authorities, legally the authorities were not responsible for their commitments. For this reason, notwithstanding the high standing of both banks, foreign banks were beginning to take their names for forward transactions with some reluctance, as the amount they had on their books already exceeded their limit. They preferred to pay a higher premium on forward dollars and forward francs if they could find another name. This state of affairs obviously weakened the efficiency of the official support. As it was impossible to conceal the fact that these two banks were acting on behalf of the authorities, it would have been as well if an official statement had been made to that effect, as it would have eliminated any doubts in the minds of foreign banks that they might take their names up to any amount.

In a little over a fortnight the first credit of £50,000,000 was exhausted. It was obvious that a much larger amount was required to restore confidence. In such circumstances it was decidedly a mistake to conclude a second credit of £80,000,000. While in July it was perhaps not unreasonable to hope that a comparatively small amount might check the flight from the pound, in August to assume that another £80,000,000 would perform the miracle required an unwarranted degree of optimism. At the same time it must be admitted that the change of Government was a point strongly in favour of sterling, and it gave rise to hopes that, as a result of the balancing of the budget, confidence might be eventually restored. From a technical point of view this assumption might have appeared sound, but it left out of account the psychological factor. Measures of extreme emergency, such as a drastic increase in taxation or radical cuts in wages, are double-edged weapons in times of crisis. Their material effect may tend to be in the long run favourable, but their immediate psychological effect may prove fatal. It would have been desirable to raise a sufficiently large amount of credit to give the Government an adequate breathing space to carry out the proposed measures. But French and American banks appeared to be unwilling to grant any credits

beyond the amount of the Bank of England's gold reserve.

It was proposed from various quarters that the stability of sterling should be assured by the mobilization of part of the British foreign investments. Admittedly there was no possibility of selling abroad any considerable blocks of securities. Owing to the demoralized state of foreign Stock Exchanges, any such attempt would have led to a disastrous slump, and would have aggravated the crisis. At the same time, in possession of a large amount of selected foreign securities such as American industrial stocks or dollar bonds, the Government would have been in a better position to negotiate with American and French banks for a larger credit in excess of the gold reserve of the Bank of England. The mere fact that the authorities were in possession of a considerable amount of theoretically marketable foreign securities would have discouraged bear speculation against sterling, which added to the pressure caused by the withdrawals of foreign funds.

The manipulation of the forward exchange rates by the authorities is open to criticism. In normal conditions the rate of exchange tends to represent the difference between the interest rates prevailing in the two countries. In August and September the banks acting on behalf of the authorities

lowered the rate at which they were prepared to sell forward dollars and francs, to a figure which was unjustified by the difference between interest rates in London and foreign centres. Possibly their tactics were meant to be a gesture, to convey their expression of confidence in the prospects of sterling. Its effect was, however, the opposite to what it was intended to be. The fact that forward dollars were obtainable at an unduly low premium encouraged the demand for forward dollars and thus increased the pressure upon sterling.

While the authorities were using up the balances of the foreign credits at an average rate of nearly £20,000,000 per week to maintain the stability of sterling in relation to the dollar and the French franc, they left the rate of the Dutch guilder entirely uncontrolled. The result was that this exchange moved below gold export point, and during the week preceding the suspension of the gold standard, large amounts of gold were shipped to Amsterdam. Possibly the authorities may have under-estimated the extent to which Amsterdam could draw upon London's resources. In fact, the gold withdrawals from Amsterdam were the last straw that broke the resistance of sterling.

Another technical error was the suspension of the delivery of sovereigns by the Bank of England.

Had the Bank discontinued to pay out sovereigns some time in July or August, it would have made but little difference, so long as it continued to part with bar gold freely, but as this measure was taken towards the middle of September when nervous tension attained its climax, it produced the worst possible impression abroad. The measure was in itself justified, as sovereigns were withdrawn mainly for hoarding purposes—a practice which had to be discouraged—but as the Bank's daily loss of sovereigns was comparatively moderate, it could well have afforded to continue the delivery of sovereigns until conditions became more settled.

It is, of course, easy to blame the authorities for these mistakes, but anyone who is inclined to condemn their policy should bear in mind that nobody in their place could have avoided making errors. It is, moreover, unlikely that, even if these errors had been avoided, sterling could have been saved. Possibly the climax might have been postponed for another few months, but it could not have been avoided altogether.

CHAPTER X

THE BANK RATE CONTROVERSY

We have seen in the last two chapters that the British authorities have been criticized for pursuing a policy of cheap money both before and during the crisis. While the other points of criticism with which we dealt in those chapters were mainly of a technical nature, the criticism of the Bank rate policy pursued raises fundamental questions of principle. We propose, therefore, to deal with these criticisms at some length. These criticisms provide a characteristic example of being wise after the event, for very few of those who are at present ready to condemn the authorities for what they consider to have been a mistaken monetary policy, suggested the necessity for a higher Bank rate previous to September 21. This, however, does not affect the merits or demerits of their arguments, which are certainly worth examining.

Several economists hold the view that, had the Bank of England adopted a policy of high money

rates as soon as the French gold drain became evident, the crisis of the pound would not have arisen. In their opinion the result of a Bank rate of, say, 6 per cent from 1927 onwards would have been a reduction in foreign lending, an increase in foreign deposits in London, a downward trend of prices in Great Britain, and a favourable trade balance in consequence. As a result of all this the Bank of England would have increased its gold reserve, and the position of sterling would have strengthened. Undoubtedly a high Bank rate from 1927 would have reduced foreign borrowing, both short-term and long-term, in London, though not nearly to the extent estimated by the Bank of England's critics. For a higher Bank rate in London would almost certainly have meant an all-round rise in Bank rates, so that the discrepancy between London and other centres would have been reduced or might even have disappeared completely. In any case, the effect of any reduction of foreign borrowing would have been neutralized by a corresponding increase of foreign deposits attracted by the higher interest rates.

Undoubtedly a higher Bank rate would have tended to bring about a fall in prices, but, as it would have been accompanied by higher Bank rates in every other country, the declining ten-

dency of prices would have been international, and would not have secured any specific advantage to British export trade. All that would have happened is that the slump of 1929–31 would have taken place two years earlier. The adjustment of wages to lower prices would have been exactly as difficult in 1928 as in 1931. In any case it would have been politically impossible to provoke a crisis deliberately by a high Bank rate policy. The economic crisis of 1929–31 was the result of circumstances over which the British authorities had no control. No statesman or financier could have dared to assume responsibility for deliberately bringing about such a calamity for the sake of doubtful theoretical advantages. Thus, the adoption of a policy of dear money in 1927 would have been both impossible and undesirable. It would not have saved sterling; in fact, it would have precipitated its fate.

Let us now examine the question whether an increase in the Bank rate during the financial crisis of 1931 would have helped to any great extent to save the pound. In the course of July the Bank rate was raised in two stages from 2½ per cent to 4½ per cent. Some economists hold the view that it ought to have been raised to about 8 per cent. The authorities are subject to attacks from various quarters for having aban-

doned the gold standard with the Bank rate at 4½ per cent, and on that ground it is suggested that they did not put up a sufficiently strong fight against the adverse tendencies. According to these criticisms the normal remedy of a high Bank rate would have been more effective than abnormal support of sterling with the aid of foreign credits. Those who hold these views appear to have overlooked, however, the psychological factor which had assumed such a predominant importance since the beginning of the crisis.

The reason why foreign banks withdrew their balances from London between July and September 1931 was that they did not trust the stability of sterling, and a higher yield on their deposits and bill holdings would not have induced them to refrain from withdrawing their funds from London. Interest is a matter of no account when the capital itself is considered to be in danger. If there is a run on a bank, it would be futile to attempt to dissuade the depositors from withdrawing their funds by offering them higher deposit rates; in fact, the higher the rate offered, the stronger the distrust of depositors is likely to be. What is true for an individual bank holds good also for a banking centre. While in normal conditions a fraction of one-sixteenth or one-

thirty-second of a per cent would be sufficient to influence the trend of funds, after the middle of 1931 considerations of interest rates practically ceased to have any influence upon international capital movements.

In the opinion of some of the critics, the effect of a high Bank rate upon the trade balance would in itself have counteracted the adverse tendency. Possibly an increase in the Bank rate to a fantastic figure might have forced industrial and commercial firms to throw their stocks of commodities on the market, and the fall of prices thereby provoked might have helped exports to some extent. But the effect of the Bank rate upon exports is a slow process, and it would have taken several months before an improvement in the trade balance would have affected the exchanges. In any case it is impossible to imagine that the export surplus thus created would have been sufficient to counteract more than a fraction of the capital withdrawals from London. During the summer of 1931 these withdrawals are believed to have amounted to at least £200,000,000. It is impossible to imagine that the trade balance could have been improved sufficiently to counteract this abnormal factor.

Bank rate worship has become an extremely popular cult among economists since the war.

It is widely believed that changes in the official rediscount rate have an all-powerful effect, and that with their aid the authorities could regulate at their will the course of economic tendencies. The experience of the last few years must surely have shaken their belief in the magical effect of the Bank rate. While in normal conditions it is undoubtedly a most important factor, in times of booms or slumps its power is very limited. The efforts of the American authorities to check the boom in 1929 by means of a high Bank rate proved to be a complete failure. Similarly the policy of cheap money adopted all over the world in 1930 in order to bring about an economic recovery produced no result whatsoever. There is no reason to believe that a policy of high Bank rates in the summer of 1931 would have made any difference to the fate of sterling.

As we have seen in the last two chapters, mistakes have undoubtedly been committed in the attempt to save the pound, but the Bank rate policy pursued by the authorities both before and during the crisis cannot very well be considered to have been mistaken. Possibly it would have been desirable to raise the Bank rate so as to show that no stone had been left unturned. Although it would have done little good, it certainly would not have done much harm; though,

had the Bank rate been raised to some fantastic figure, it would have resulted in the wholesale failure of business firms. The effect of such failures would have been to increase foreign distrust in British banks, and this again would have accentuated the withdrawal of foreign funds.

CHAPTER XI

SUSPENSION OF THE GOLD STANDARD

Towards the end of August it was hoped that, as a result of the change of government and of the drastic measures taken for balancing the budget, the pound might be saved. Early in September it was realized, however, that the authorities were fighting a losing battle. It was known that day after day the second credit of £80,000,000 had had to be drawn upon heavily in order to prevent a depreciation of sterling below gold export point. It was also realized that the authorities could not allow the gold reserve to decline below £130,000,000, because that amount just covered the Franco-American credits. Thus the exchange had to be kept at all costs above gold export point, in spite of the persistent pressure caused by the outflow of foreign funds. During August and September the pressure was aggravated by bear speculation in sterling on a large scale. Considering that the limit of the possible losses on selling short sterling was

only a fraction of 1 per cent, while the extent of the speculative profit was estimated at at least 25 per cent, speculators had every inducement to operate against sterling.

Towards the middle of September it was becoming increasingly evident that the suspension of the gold standard was merely a question of days. The Invergordon affair, which was grossly exaggerated in the continental Press, accentuated the flight from the pound, and it was an open secret that the unused balance of the Franco-American credits was dwindling rapidly. By September 18, practically the whole amount was used up. There was no alternative for the authorities but to suspend the gold standard. Had the budget been balanced some months earlier, possibly it might have gone a long way towards restoring confidence. At this late stage, however, it failed to produce any substantial effect, as everybody believed that the process undermining the stability of sterling had reached a phase too advanced to be checked by any budgetary measure, especially as the problem of sterling was not primarily a budgetary problem. It was, indeed, impossible to imagine that eleventh-hour emergency measures could save the pound. Had a tariff been introduced some months earlier, its effect upon the trade balance and its psychological effect might have

made a considerable difference. It was impossible to expect, however, that in September a decision to introduce a tariff would obviate the suspension of the gold standard. Even if there had been an adequate majority in Parliament in favour of the measures, their introduction would have taken several weeks, and meanwhile their anticipation would have resulted in increased imports and increased pressure upon sterling.

It has been suggested in some quarters that drastic cuts in wages might have saved sterling. Anyone acquainted with the political power of trades unions and with the effect of unemployment relief upon wages, ought to realize, however, that any attempt at an all-round reduction of wages would have met with the utmost resistance on the part of workmen. Apart from a few isolated instances, attempts at wages reductions during 1931 invariably failed. Had the authorities and employers insisted upon drastic cuts in September, it would have led to a series of strikes which in themselves would have been sufficient to cause the suspension of the gold standard. The attitude of the Atlantic Fleet towards reductions is in itself sufficient to indicate what could have been expected as the result of attempts at wage cuts on a large scale.

One of the reasons for the lack of confidence

in the stability of sterling was the uncertainty of the internal political situation. The National Government's majority was very narrow and uncertain. It was thought that before very long it would become necessary to dissolve Parliament and have a General Election. Nobody was certain what the outcome of the General Election would be. It was feared that the Labour Party might come in with a clear majority, in which case the hopes of a stabilized budget and of gradual wage reductions would vanish, and the flight of British capital would become accentuated. The Government was confronted with a rather awkward dilemma. Many of its adherents urged the necessity of an early General Election so as to obtain a working majority in favour of tariffs and other measures necessary to save sterling. Others again were opposed to the utmost to a General Election because they were afraid that sterling would not stand the additional strain caused by the excitements of the electoral campaign. The Government realized that these arguments were well founded, and that in the case of a General Election it would be highly probable that the gold standard would have to be suspended before the date of the Election. On the other hand it also realized that as a General Election was regarded as a mere question of time,

the prolonged state of uncertainty would lead to a persistent pressure on sterling. The choice was between sudden and violent pressure caused by an immediate General Election, and a less violent, but persistent and prolonged pressure caused by the anticipation of a General Election at some future date. Whichever alternative was chosen, sterling was doomed.

From an external political point of view the defence of sterling had also been made impossible by the attitude of France. The policy pursued by the French authorities during 1929–31 was largely responsible for the weakening of London's position. Late in July 1931, the French authorities realized that the danger of a suspension of the gold standard in Great Britain was imminent, and realized the unfavourable effect of such a development upon French interests. Accordingly they suddenly changed their attitude, and began to support sterling. At first the Bank of France was buying sterling on its own account during the last week of July and the first few days of August, and subsequently it supported sterling by participating to the extent of 50 per cent in the credits arranged for the Bank of England and for the British Treasury. At the same time, the French Press, which until then did its utmost to increase distrust in ster-

ling, changed front and made a belated attempt to create optimism as to the prospects of the gold standard in Great Britain. France wanted, however, to be paid a price for her support, not merely in the form of interest and commission on the credits, but also in the form of obtaining the right to influence Britain's foreign policy, and even to interfere with her domestic affairs. The attitude of the inspired French Press left no doubt about this. It was pointed out day after day that financial co-operation should be associated with political co-operation between the two countries. When in September it was suggested in England that, in order to defend sterling the import of luxury articles should be prohibited, or that a high tariff should be introduced against them, this unofficial suggestion provoked a wave of indignation in the French Press, and French politicians made unequivocal allusions to the consequences of any such measures. The first credit of £50,000,000, in which France participated to the extent of £25,000,000, was only granted for three months, and was to fall due on October 31. Although it was promised that it would be renewed for another three months, there is reason to believe that under the pressure of public opinion, the French authorities would have demanded as a price for renewal certain concessions of a poli-

tical nature as well as an undertaking to abstain from restricting the import of French goods. No self-respecting nation could possibly tolerate such interference with the independence of its policy. Even if it had been possible to save sterling at the price of submitting to French dictation as to Great Britain's attitude in international affairs and her tariff policy, the result would not have been worth the sacrifice. It is doubtful whether any British statesman, if confronted with the dilemma whether to suspend the gold standard or to save it at the price of the political independence of the nation, would have chosen the latter alternative. In any case the dilemma did not arise, for it became obvious that even with French support the pound could not be saved. On September 18 the British authorities informed the French and American authorities that they had very nearly exhausted the credits available, and that consequently the gold standard would have to be suspended within the next few days. Another attempt was made to arrange credits to continue the defence of sterling. It is stated that the French authorities were prepared to participate in a third credit to the extent of £32,000,000. The American authorities were, however, unwilling to participate, as they duly realized that this credit would be used up in the same way as the first two. Judging

by the withdrawals during the third week of September, a credit of £60,000,000 to £70,000,000 would have been used up within a week or so. As the whole of the £130,000,000 of gold reserve was practically earmarked for the existing credits, it was highly risky for the British authorities to conclude any further external short-term credits, for in doing so they would have delivered themselves up to the mercy of either the foreign exchange market or the lending authorities by the necessity of repaying or renewing the credits. In any case the French authorities were not prepared to grant any further credits without American participation. It was, therefore, impossible to continue to maintain the stability of sterling any longer after September 19. The British authorities had to bow their heads to the inevitable, and announced the suspension of the gold standard as from September 21.

It was not the first time that Great Britain had departed from monetary stability. As recently as during and after the Great War sterling had to be allowed to depreciate, and was at a discount in relation to gold for over ten years. On that occasion, however, the exceptional situation created by the war was responsible for the suspension of the gold standard, which in any case was regarded as a purely temporary measure. Everybody was

convinced that sooner or later sterling would be restored to pre-war parity. On the present occasion, on the other hand, sterling was forced off the gold standard in time of peace, and the number of those who expected it ever to return to its pre-war parity was very small. The change of 1914 was regarded as a mere passing phase, a necessary evil associated with the war. The change of 1931, on the other hand, had the character of finality, and was regarded as being the conclusion of a period in British financial history. During and after the war most other currencies depreciated and fluctuated at the same time as sterling. In fact, sterling was more stable than most continental currencies. In 1931, however, sterling departed from stability at a time when almost every currency was stable. With the exception of the peseta, the silver exchanges and some of the South American currencies, monetary stability was complete in 1931.

Another essential difference between the suspension of the British gold standard during the war and during the international economic crisis, is that on the first occasion the suspension was accompanied by internal inflation, while in the present case it was due to international factors. This should be borne in mind in face of the criticisms directed, especially from abroad, against the

British authorities. It is true that budgetary conditions were far from ideal, but in this respect Great Britain did not stand alone. As a result of the crisis practically every government had a more or less substantial deficit in 1931. The United States Government had a huge deficit, while the French position was also far from satisfactory. The suspension of the gold standard was largely the result of international factors over which the British authorities had no control. If the depositors of a bank lose their heads and demand the reimbursement of all their deposits at the same time, they have no right to blame the bank if it is unable to meet such an abnormal demand. After all, it is the bank's task to reinvest the funds entrusted to its charge, and no bank or banking centre is able to withstand the pressure of a general run. In comparatively normal conditions they may be saved by assistance from other banks or other banking centres. But, owing to the conditions created by the international crisis, every other bank and every other centre had to look after its own safety, and it was impossible to secure a sufficient amount of assistance to save sterling.

CHAPTER XII

IMMEDIATE EFFECTS

To those in close touch with the Foreign Exchange Market the announcement of the suspension of the gold standard did not come as a surprise. The British public was, however, taken completely unawares, as until the very end it was considered unbelievable that Great Britain should suspend the gold standard. Even towards the middle of September, when the suspension was merely a question of days, the average intelligent Englishman would have scorned any suggestion that such a thing might ever happen. He trusted the authorities implicitly, and was convinced that, in spite of the adverse conditions, they would find a way to maintain the stability of sterling. As for the man in the street, he was convinced that, Great Britain would muddle through somehow, and was not particularly worried about the situation. The Press was not in a position to prepare the public for the change, for any indication as to the possibility of the suspension

would have been regarded as unwarranted defeatism. It is true that in some quarters it was suggested that Great Britain should deliberately abandon the gold standard, but as such suggestions had been made from time to time ever since the war, they were regarded as purely academic. Public opinion abroad was less confident owing to the pessimistic attitude of a large section of the foreign Press, but even in foreign countries many people were inclined to believe that sterling would retain its stability.

It took some time even for financial circles to grasp the meaning of the change, the immediate reaction to which was entirely different from what was anticipated. In banking circles, it was feared that the announcement might cause a panic amongst the public. Indeed, the atmosphere during the week that preceded the suspension had been charged with nervous tension. Stock Exchange quotations declined to low records, and an inexplicable feeling of uncertainty was weighing upon the markets. It was feared that the suspension of the gold standard might result in heavy withdrawals of deposits. Actually, however, nothing of the kind happened. On Monday, September 21, the banking halls were remarkably empty, and the volume of withdrawals was even less than usual. There was, indeed, no

reason for the British public to worry about their deposits. The position of the banks was calculated to improve as a result of the suspension of the gold standard, for the revival of trade which should follow the depreciation of sterling was calculated to release some of their frozen assets in Lancashire and elsewhere. But such considerations played no part in determining the attitude of the average depositor, who was not in a position to foresee the effects of the change. The reason why the British public remained calm lies in its implicit confidence in the leading banks, which is fully justified by sound banking traditions. It is, moreover, one of the fundamental characteristics of the British nation to remain calm in face of emergency.

The attitude of the popular Press also contributed to the unexpectedly favourable reception of the bad news. While the serious newspapers sought to justify the measure as the result of inevitable necessity, the popular newspapers, with their usual habit of exaggeration, received it triumphantly, and regarded it as a highly satisfactory development. "Thank goodness, we are off the gold standard!" was the favourite Press stunt, and the public took it up at once. Remarks to that effect were heard in trains, in shops, in the street, wherever acquaintances met during

the days that followed the announcement. This is not at all surprising. Economic conditions in Great Britain had been unsatisfactory for some years, and during the last two years they had been developing from bad to worse. The public, though unable to grasp the connection between the gold standard and the economic crisis, felt that any change was bound to be for the better, as it could not possibly be for the worse.

Foreign observers, while admiring the British public for their calm attitude, were somewhat surprised and shocked at the apparent feelings of relief which manifested themselves spontaneously after the change. Undoubtedly it would have been perhaps more dignified to adopt an attitude of calm resignation in face of the inevitable event. But those who were shocked at the apparent light-heartedness with which a century-old tradition was discontinued, failed to understand the British character, which always aims at concealing its real feelings. To a great extent the attitude of relief and satisfaction was on the surface only, and was to cover the deeper-lying feelings of grief over the blow received through the suspension of the gold standard.

While the feeling of relief appeared to be unanimous among the general public, opinions were sharply divided among experts. At one extreme,

a number of academic economists were shocked and indignant. They would have preferred to see Great Britain bleeding to death economically and financially rather than abandon the fight so long as there seemed to be a chance to hold out. As they were unaware of what was happening behind the scenes, and were hopelessly out of touch with realities, they did not realize that there was no alternative. The other extreme was represented by a comparatively small number of radical economists who, for years past, had advocated the abolition of the gold standard and who were naturally overjoyed by the development of events. In banking circles the change was received with mixed feelings, as it was impossible to foresee its consequences upon the international banking situation. It was feared that amidst the nervous tension that prevailed in every financial market, any violent change might result in a general panic and complete financial and economic collapse. On the other hand, bankers in this country could not help feeling relieved after the prolonged period of suspense which, during the last weeks, had become accentuated to an almost intolerable degree. When, after the first few days, it became evident that the suspension of the gold standard was not causing a panic in any part of the world and least of all in London, British

banking circles adopted an attitude of guarded optimism. In industrial and commercial circles, the change was greeted with satisfaction and even enthusiasm. For years past, there had been a widespread belief among industrial interests that the restrictions imposed upon financial activity by the management of the gold standard had been responsible for the depressed state of industries. For this reason alone, they welcomed the change. In addition, they realized that the depreciation of sterling meant rising prices and that rising prices meant increasing industrial and commercial activity. After two days of enforced idleness, the Stock Exchange responded to the change by a rapid rise in industrial shares, which created a cheerful tone, notwithstanding the simultaneous decline in Government bonds and other fixed interest bearing securities.

While the immediate effect of the change in Great Britain was thus on the whole decidedly favourable, the news caused considerable anxiety in foreign countries. Banks all over the world held sterling deposits, the amount of which was, in many cases, considerable, notwithstanding the heavy withdrawals that had been going on for the past few months. It became evident that many banks, including most central banks, would have to write off heavy losses on account of the

depreciation of their sterling balances. On the other hand, the debtors of London felt gratified by the automatic reduction of the burden of their debts in terms of their own national currency. The chief source of anxiety abroad was the anticipated effect of the change upon British import and export trade. Foreign exporters realized that a depreciation of sterling meant to them the loss of at least part of their British trade, and also sharp British competition in every market.

The suspension of the gold standard was followed by a sharp break in sterling exchange. On the first day the depreciation of sterling attained nearly 20 per cent, while during the following days it became further accentuated. To some extent this was due to the withdrawal of foreign deposits. Many foreign holders of sterling were anxious to cut their losses, and their urgent demand for foreign currencies was the principal reason for the weakness of sterling. The extent to which the flight of British capital contributed to the depreciation was negligible. The restrictions upon the purchase of foreign currencies prevented any considerable flight of British capital, and, moreover, after the depreciation of sterling to about $4, most people in Great Britain were inclined to think that the limit had been reached. In

any case the volume of business in the foreign exchange market during the first few days after the suspension was too small to make it easy to transfer any large amounts from London. The market became completely disorganized in consequence of the change. Owing to the uncertainty of the outlook, bankers were extremely cautious in their foreign exchange dealings, and avoided taking any risk. During past years any violent movements in exchanges had been accompanied by feverish speculative activities. On this occasion, however, the amount of speculative activity immediately after the suspension was negligible. This was due to the effect of the prolonged crisis, as a result of which considerations of profit had faded into the background. Bankers were willing to forgo any profits for the sake of avoiding risks and maintaining their liquidity. Thus, while in the past they had willingly executed orders on behalf of speculators, after September 1931 they were extremely careful in scrutinizing orders received from their clients. Business came to an almost complete standstill in the forward exchange market. The number of banks whose names were accepted for forward dealings was reduced to a negligible figure. The absence of adequate forward exchange business caused considerable inconvenience to trade,

as business men were thereby prevented from covering their exchange risks.

The immediate effect upon the Stock Exchange was entirely different from what was expected. The authorities anticipated a panic, and the Stock Exchange was kept closed for two days. In reality, however, while there was a weak tendency in Government stocks, the market in industrial shares displayed a feverish activity after the reopening of the Stock Exchange. It was taken for granted that industries were bound to benefit by the depreciation of sterling, and besides, investors were anxious to convert their holdings of fixed interest bearing securities into equities. For some days there was an indiscriminate rising trend in ordinary shares, which tended to assume exaggerated dimensions. The authorities, who, until a few days before, feared a collapse, were compelled in less than a week to impose restriction upon dealings so as to prevent an exaggerated rise.

Commodity prices responded instantaneously to the depreciation of sterling. There was a sharp rise in the wholesale prices of almost every kind of commodity, in many instances exceeding the percentage of the depreciation of sterling. On the other hand, retail prices remained remarkably steady, and in many instances showed even

a declining trend. This apparent anomaly was due in part to the inelasticity of retail prices. During the period of the decline in wholesale prices, the decline of retail prices lagged far behind that of wholesale prices, so that in September 1931 there was a considerable discrepancy between them. Another reason why retail prices failed to respond to the changed tendency was the absence of any inflation and the curtailment of the purchasing power of the public by heavy taxation. In this respect the British experience differed considerably from the inflationary experiences of continental countries. Throughout the post-war period depreciation of the exchange in any country was accompanied by an increase in purchasing power, which was bound to result in a rise in retail prices. In Great Britain in 1931, however, the depreciation of sterling coincided with a reduction in purchasing power through higher taxation, and with a campaign to enforce economy in every direction. Moreover, the British nation lacked what is termed on the Continent "inflationist mentality". In countries such as Germany and Austria, which underwent a currency depreciation after the war, the first symptoms indicating the recurrence of that experience would result in reckless buying of commodities in anticipation of a rise. In Great Britain, however,

the public had no inflationist experience, and did not anticipate a heavy rise in commodity prices as a result of the change. Apart from that, nobody in Great Britain believed that the depreciation of sterling would assume considerable dimensions. When towards the end of September the dollar rose to a premium of about 30 per cent, everybody was convinced that this was about the limit beyond which sterling was not likely to go.

CHAPTER XIII

INTERNATIONAL EFFECTS

WHILE the internal effect of the suspension of the gold standard was comparatively moderate, its international repercussions were grave and widespread. The important part played by sterling in international finance and trade was only fully realized at the moment when it ceased to be an international currency. No financial event has produced such a tremendous effect all over the world and in every branch of economic life as the suspension of the gold standard in Great Britain. Its immediate effect was to aggravate the financial crisis, and to inflict heavy losses upon innumerable banks and commercial firms. In the long run, however, the consequences of the suspension of the gold standard in Great Britain are likely to prove highly beneficial. In fact, it is possible that the change may prove to be the turning point in the whole crisis. In the present chapter we shall confine ourselves to examining the immediate international effects.

The following is a summary of the immediate international consequences of the suspension of the gold standard:

(1) It compelled a number of other countries to suspend the gold standard or the gold exchange standard.
(2) It increased the feeling of uncertainty as to the stability of a number of currencies.
(3) It brought about a sharp rise in the price of silver.
(4) It inflicted heavy losses upon a number of banks, including most central banks.
(5) It inflicted heavy losses upon a number of commercial firms having contracts in terms of sterling.
(6) It relieved the burden of debtors whose debts were expressed in terms of sterling.
(7) It brought about a rise of produce prices in the world markets.

It was to be expected that a large number of countries would follow Great Britain's example in suspending the gold standard. In the first place, as Great Britain led the way in 1925 in restoring the gold standard, many countries which experienced difficulties in maintaining the stability of their currencies were expected to take this opportunity to abandon the fight. While a few months earlier departure from gold would have been regarded as incompatible with the dignity of a nation, once Great Britain took such a step it was unnecessary to consider the question of prestige.

Apart from this, commercial considerations were also at work to induce several governments to follow the British example. The depreciation of sterling acted as a customs barrier against imports from countries on a gold basis. In countries whose prosperity depended upon the British market, such as Denmark for instance, the currency had to be allowed to depreciate to about the same extent as sterling so as to secure the continuation of British purchases. The psychological effect of the suspension of the gold standard was also expected to compel a number of countries to follow the British example.

In the circumstances the number of countries which actually abandoned the gold standard soon after September 21 was surprisingly small. The Scandinavian countries were the first to follow the lead. Sweden had had to struggle for some time past with adverse tendencies brought about by the repatriation of Swedish securities placed abroad during the previous few years. As she did not succeed in raising a credit abroad, she was unable to remain on a gold basis. Norway and Denmark followed her example mainly for commercial reasons, although presumably it would have been impossible for them to remain on a gold basis once Sweden had abandoned it. A little later Finland joined the other Scandinavian

countries. Among the Empire currencies, the rupee remained linked with sterling, and depreciated, therefore, in relation to the gold currencies. India stands to benefit greatly through this change, which will protect the market against imports from countries on a gold basis. Portugal, which recently stabilized the escudo in relation to the £, maintained the exchange rate of 110, and the escudo automatically depreciated in relation to gold currencies. The Australian pound had ceased to be a gold currency some time previously, and, together with the New Zealand pound, it remained linked with sterling. The currencies of the Crown Colonies and of various Protectorates such as Palestine and Iraq remained on a sterling basis. The same was the case with the Egyptian pound and the currency of the Irish Free State. On the other hand South Africa refused to abandon the gold standard, while Canada, in spite of the depreciation of her currency, made desperate efforts to remain linked with the United States' dollar.

It was believed that Italy, Germany and other Central European countries, as well as Eastern and South-Eastern Europe, would soon follow the British example. For this reason the depreciation of their exchanges was anticipated in the foreign exchange market, and for a short time the flight of capital and bear speculation brought about a

sharp depreciation of some of these currencies. Drastic measures were, however, taken by the authorities in the countries concerned, and the stability of their exchanges was eventually restored. In most cases exchange restrictions were introduced, and the central banks used up a considerable portion of their gold and foreign exchange reserves to support their currency. The wave of distrust against the stability of currencies attained such proportions that for awhile even the stability of the dollar was doubted.

The other side of the picture was a sharp rise in the price of silver. This was due to no increase in the actual demand, but to a revival of talk about the return to bimetallism. The remonetization of silver came very much to the fore, and was being advocated even by certain highly conservative quarters. As a result, the currencies of countries of the Far East underwent a marked appreciation.

Although a considerable part of the sterling balances of foreign banks was withdrawn during the three months that preceded the suspension of the gold standard, the amount left in London at the moment of the suspension was, nevertheless, considerable. Consequently, holders of these balances suffered heavy losses as the result of the depreciation of sterling. Banks in every part of the world will have to write down losses on ster-

ling balances, although in many cases their extent was mitigated by the reduction of their liabilities in terms of sterling. Generally speaking, the losses of commercial banks and private banking firms on their sterling balances were not excessive. Most of them had reduced their holdings considerably before September 21, or had covered the exchange risk by forward exchange operations. In some cases, however, foreign banks granted loans in terms of sterling, and this caused them considerable losses. The central banks were the principal victims of the depreciation. Almost every central bank had a sterling balance. As a result of the adoption of the gold exchange standard many of them kept a substantial part of their note cover in the form of sterling bills or deposits, while even central banks on a gold bullion basis had important sterling balances. The amount of the sterling balances of the Bank of France alone was £62,000,000. While commercial banks and other holders of sterling reduced their holdings considerably previous to the suspension, most central banks were reluctant to increase the difficulties of the Bank of England, and left their balances untouched. As a result, the depreciation of sterling caused them heavy losses. Moreover, as according to their statutes they are only entitled to include currencies on a gold basis in their note cover, the departure

of Great Britain from the gold standard compelled a number of central banks to exclude sterling from their reserve. In some cases this necessitated emergency measures so as to fill the gap thus created. The immediate effect of the loss suffered by central banks was the wholesale repatriation of their dollar holdings in the form of gold. The consequence of this will be dealt with in the next chapter.

The depreciation of sterling provided an unexpected windfall to a large number of debtors all over the world. Most of the foreign loans issued in London were issued in terms of sterling, and the loan agreement did not contain either a gold clause or an option for payment in other currencies. As a result, debtors are now able to discharge their liabilities in terms of depreciated sterling. Similarly the burden of short-term debts to British banks and exporters became automatically reduced. This provided substantial relief to Germany and other foreign countries. It induced a number of debtors to repay their debts, as there was a possibility of a marked recovery of sterling which might have reduced the advantage they gained from the depreciation.

One man's meat is another man's poison. While debtors derived substantial benefit from the depreciation of sterling, creditors suffered losses to

a corresponding extent. In the case of British creditors the loss was not so obvious as they continued to receive the same amount of sterling as before. But in the case of creditors in other countries the receipt of the same amount of sterling involved a loss in their own currency of from 20 per cent to 25 per cent. Foreign merchants who had undertaken to deliver goods against payment in sterling suffered equally heavy losses. At the beginning attempts were made to escape liabilities by insisting on payment in sterling at gold parity, but such claims had no legal foundation, and in most cases they had to be abandoned eventually. In some cases, however, the sellers refused delivery, and the disentanglement of lawsuits resulting from these affairs will keep lawyers busy all over the world for some years. The extent to which sterling served as an international currency was not realized until after the suspension of the gold standard, when litigations were reported from every part of the world. German machinery was sold in Soviet Russia in terms of sterling. It was reported from Paris that Roumanian grain exporters had refused to carry out their contracts fixed in terms of sterling. The price of coal sold by Poland to Scandinavia was fixed in sterling. Italian textile works had to suffer heavy losses through their being paid in sterling for their consignments of

cotton goods to China. As sterling was regarded as the symbol of monetary stability, most merchants did not consider it necessary to cover the forward exchange for goods sold in terms of sterling. In various countries the heavy losses involved resulted in a number of commercial failures.

The suspension of the gold standard thus caused general confusion, and its immediate effect was to accentuate the world crisis. At the same time it brought us nearer to the climax and therefore nearer to recovery.

CHAPTER XIV

THE DOLLAR "CRISIS"

For some time after Great Britain's departure from the gold standard it appeared as if this act would bring about an international monetary collapse. Few people believed that vulnerable currencies such as the reichsmark, the Austrian shilling, the Hungarian pengo, or even currencies such as the lira, would be able to stand the strain caused by the psychological effect of the change. It appeared for some time as if the conditions of the post-war currency chaos would return. Confidence in the stability of all but three or four currencies disappeared. Forward reichsmarks were for some time absolutely unsaleable, and there were no buyers even at a discount at which a purchase would give a yield of something like 75 per cent per annum. While this wave of distrust in vulnerable currencies was not altogether unreasonable, towards the beginning of October it was inclined to assume ex-

aggerated proportions, and threatened to spread in directions where there was in reality nothing to fear.

During the first week after the suspension of the gold standard in Great Britain the funds withdrawn from London whether on foreign or on British account were transferred mostly to New York. The dollar has been regarded ever since the war as the safest currency in the world, because of the enormous gold stock held in the United States. Thus, those holders of sterling who did not wish to repatriate their funds transferred them to New York. Towards the end of September, however, a turn of the tide became noticeable. The depreciation of sterling by something like 20 to 25 per cent induced many British holders of dollar balances and securities to take advantage of the favourable exchange rate of the dollar by repatriating their funds. At the same time foreign central banks began to repatriate their dollar holdings in the form of gold. As we observed in the previous chapter, most of them suffered heavy losses from the depreciation of sterling, and in most countries there was strong pressure of public opinion against the gold exchange standard, and even against the practice adopted by some central banks of keeping part of their funds abroad. Large amounts of gold were earmarked on account of European

central banks, and considerable amounts were engaged for shipment.

The unprecedented size of the gold efflux caused considerable alarm all over the world. In the past, the fact that a central bank parted with gold freely was always regarded as a reassuring sign, and tended to restore confidence. It is an old-established rule that the best way for a bank to meet a run is to pay out freely, as in doing so it may allay the depositors' fears. During the second half of 1931, however, this rule did not seem to have operated satisfactorily. In the case of both the Reichsbank and the Bank of England, the heavy efflux of gold, far from restoring confidence, accentuated the uneasiness, and aggravated the crisis in consequence. It was feared that the same would be the case with the United States. It was not realized that there was a fundamental difference between the position of Great Britain and Germany on the one hand and that of the United States on the other. While the external short-term liabilities of the two former countries were much in excess of the gold reserves of their central banks, the external short-term liabilities of the United States were covered about twice over by her gold stock. It is true that the whole of her gold stock could not be regarded as being available for export, as, on the basis of the Federal Reserve regulations,

the greater part of the gold reserve had to serve as note cover. But the amount of free gold was none the less considerable, and, if it came to the worst, the Federal Reserve regulations could have been suspended.

Notwithstanding these considerations, a feeling of uneasiness as to the future of the dollar continued to prevail throughout October. There were persistant withdrawals of bank balances from New York, and the dollar was constantly in the vicinity of gold export point. So, in addition to withdrawals on account of central banks, there were also heavy shipments on account of abitrageurs. Moreover, the American authorities themselves arranged substantial shipments so as to provide funds for supporting the dollar exchange. Such support was indeed necessary so as to avoid the depreciation of the dollar below gold export point. Although in theory the exchange of a country which has a free gold market cannot decline below gold export point by more than a fraction, in practice substantial discrepancies may arise for technical reasons. Shipping facilities for gold are rather limited. In normal conditions only first-class mail boats carry gold, as loss of interest and higher insurance rates make it unprofitable to employ slow boats for that purpose. In October, however, the amount of gold that required

to be shipped was well in excess of the facilities provided by the fast boats, and large amounts were shipped also in slower steamers. As a result of the increased demand for insurance, the rates of insurance rose from one shilling per £100 to over six shillings per £100; thus, the gold point shifted considerably below its normal figure. From time to time the selling of dollars by those desirous of withdrawing their funds assumed such dimensions that the exchange tended to depreciate below its gold point. This was, fortunately, prevented by the support arranged by the American authorities. Nevertheless, as their activities were focused upon maintaining the stability of the dollar in relation to the French franc, it occurred occasionally that in some remote markets, such as Warsaw, there was a local dollar panic, and holders were willing to sell at a discount of 5 to 6 per cent.

One of the main causes of the widespread uneasiness as to the prospects of the dollar was the attitude of the French authorities. It was well known that the Bank of France, the French Treasury and the Caisse d'Amortissement had between them something like $600,000,000, mostly in the form of sight deposits. On the basis of past experience, it was taken for granted that they might use their financial power to bring political

pressure to bear upon the United States. It was generally known that the French Government was determined to do its utmost to prevent President Hoover from repeating his magnanimous gesture of June 1931 in the matter of war debts. Although nothing definite was known in Europe about President Hoover's intentions, he was credited with preparing a proposal for a prolonged debt holiday, or for a radical scaling down of war debts and reparations. French official circles realized that any French opposition to such proposals would result in the political isolation of France, and this they were naturally anxious to avoid. They endeavoured, therefore, to dissuade President Hoover from taking the initiative. Before M. Laval's visit to Washington, representatives of the Bank of France were sent to negotiate the technical terms on which the French authorities were prepared to leave their balances. An informal agreement was soon reached, but it was understood that it would depend on the outcome of the Washington discussions between President Hoover and M. Laval. Thus it was feared that, should these discussions result in a deadlock, the French balances might after all be withdrawn. Although the American authorities could well afford to export $600,000,000 in gold, it was feared in many quarters that such a spectacular efflux, which might possibly be

further accentuated by withdrawals on account of other countries, might bring about a panic in Wall Street and a run on the banks. For this reason the outcome of M. Laval's visit was awaited with considerable anxiety.

It is hardly necessary to point out that this anxiety was unjustified. Banking circles in New York were not in the least afraid of losing their French deposits, as was shown by their unanimous decision to refuse the French demand for a higher deposit rate. They adopted the view that New York would be better off without these deposits, which only caused inconvenience and unsettled the market. This attitude could have easily been worked up into a strong public feeling which might have provided adequate safeguards against the adverse psychological effect of the withdrawal of the French dollar balances. The American authorities held, however, a different view, and preferred to conclude a compromise with France.

Another source of uneasiness abroad was the persistent hoarding tendency on the part of the American public. The actual amount being hoarded at that time week after week was not very large; it compared rather favourably with the spectacular increase of the French note circulation throughout September and October. The

adverse trend of the dollar was also due to a great extent to bear speculation. As in the case of sterling, it appeared a tempting proposition to sell dollars short, for the extent of possible loss was limited to rather less than one per cent while the extent of possible profit appeared to be considerably greater.

Towards the end of October a favourable turn of the tide set in. This was largely due to the understanding reached in Washington, which confirmed the agreement concluded between the French and American monetary authorities in New York. As a result it was understood that French official deposits would not be withdrawn for the time being, and part of them was reinvested in three months bills. Although the gold drain continued for some time, and the dollar did not immediately rise considerably above gold export point, fears of a suspension of the gold standard were allayed. Heavy bear covering before the end of the month also contributed to accentuate the turn in the trend. At the beginning of November confidence in the dollar was completely restored.

The developments during October are held to prove that, no matter how strong a banking centre is, it can be seriously embarrassed by the simultaneous withdrawal of its foreign funds. It appears,

therefore, that the possession of an international financial centre is a doubtful blessing for a country in an emergency, as it is certain to aggravate the difficulties that may arise.

CHAPTER XV

EFFECT ON WORLD PRICES

ALTHOUGH at this stage it would be premature to form a definite opinion as to the consequences of Great Britain's departure from gold, it is nevertheless possible to point to certain indications of fundamental tendencies which it set in motion. While the immediate effect of the suspension of the gold standard was decidedly harmful from an international point of view, there is every reason to believe that in the long run the effect will be definitely beneficial. It is even possible that the violent change has broken the vicious circle of the economic depression.

The world economic crisis, which began with the Wall Street slump at the end of 1929, resulted in a complete economic deadlock by the second half of 1931. It differed fundamentally from previous economic crises. Before the war the recurrence of economic depression every seven or eight years was regarded as a normal part of our economic system. Many economists held the view

that the progress of mankind could not be imagined without these periodical setbacks which were considered, in a way, useful, as they readjusted excessive growths or abnormal tendencies. Even those who regarded them as an inevitable evil, admitted that, inconvenient as they were, the damage they could do was comparatively moderate, as they set in motion tendencies which sooner or later brought about a general economic recovery. Thus, if the crisis was due to over-production, a corresponding fall in prices enabled the world to absorb the surplus. If it was due to monetary influences, the abnormal monetary tendencies were counteracted by the tendencies created by the crisis. If the fall in prices which brought about the crisis was due to the inadequacy of gold supplies, the decline in prices resulted in a corresponding decline in requirements of gold, and at the same time stimulated production.

In the crisis of 1929–31, however, these tendencies making for readjustment and for the restoration of normal conditions apparently failed to operate. In spite of the decline in prices a shortage of gold continued to prevail owing to the hoarding of gold by a few countries. The lowering of interest rates to a nominal figure failed to stimulate business activity, and lower prices failed to stimulate the demand for the unsaleable surplus stocks of produce

and manufactures. The reason for this is that a further deflation was generally anticipated. There were reasons for supposing that the maldistribution of gold, which was the cause of the decline, would become further accentuated, mainly as a result of the gold-hoarding policy of France. As a further fall of world prices was generally anticipated, low prices were unable to attract buyers, and low interest rates were unable to attract borrowers. By the middle of 1931 the deadlock was complete. Adverse economic tendencies were chasing each other in a vicious circle. The decline of prices inflicted heavy losses upon everybody, and undermined confidence. This again resulted in a withdrawal of credits by the principal creditor countries, which in turn tended to accentuate the maldistribution of gold. The latter factor again tended to accentuate the decline of prices, and so it went on.

It seemed as though there was no way out. Suggestions for the remonetization of silver in order to increase the amount of monetary gold available, met with no response, and it appeared as though the insufficiency of gold stocks would strangle the world.

The suspension of the gold standard by Great Britain and by a number of other countries provided the much-needed safety valve. Although

the change did not cure the maldistribution of gold, it restricted the territory on which the gold standard remained in force. Great Britain's example was followed by a large number of other countries. As a result, Great Britain and most parts of the British Empire, Northern Europe, South America, and certain parts of the Near East have become independent of gold. Even if the process of deflation were to continue in countries on a gold basis, it might not affect prices in those countries which have abandoned the gold standard. Thus, even if economic depression continues in one half of the world, a moderate revival may take place in the other half, which eventually may react favourably on the gold-using countries. But there is a fair chance that sooner or later the rising trend will spread over the gold-using countries. We have seen in Chapter XII that the immediate result of the depreciation of sterling was a rise in wholesale prices. This may have been due to temporary factors such as increased demand by Great Britain in anticipation of higher prices, but it certainly tended to improve the situation of the produce markets. Surplus stocks in most countries, which a short time before had been regarded as unsaleable, and were condemned to destruction, underwent in many cases a sudden decline, or at least a sharp check in their rate of

increase. The wheat situation was generally regarded as more healthy. Those who are aware of the important part played by the decline of wheat prices in the economic depression will undoubtedly realize what this meant.

Unfortunately the favourable tendency that set in after September 21 in the world markets was not allowed to continue unhampered. Incredible as it may sound, the authorities of the principal gold-using countries took steps to check the upward trend of prices by the adoption of a deliberate deflationary policy. At a time when everybody realized that the crisis was largely due to the fall in prices, and that the only hope for a substantial recovery lay in the possibility of a rise, the French authorities succeeded in persuading the American authorities to join them in a crusade against rising prices.

To some extent it was undoubtedly necessary to raise interest rates from the abnormal level to which they were reduced during the crisis in the hope of bringing about a revival. It was evident that in the existing circumstances low interest rates were unable to produce the desired effect. They had moreover the disadvantage of encouraging the hoarding habit both in France and in the United States. In both countries the suspension of the gold standard in Great Britain

was followed by a series of runs on banks. While in the United States the movement confined itself to small and medium-sized banks, in France even the big banks were not altogether spared. As a result, the note circulation tended to increase in both countries, especially in France. The authorities assumed that the withdrawal of deposits from the banks was largely due to the inadequate remuneration brought about by the reduction of the interest rates. If depositors are only paid ½ per cent per annum, there is not sufficient inducement for them to keep their money in the banks, and the least cause is sufficient to induce them to withdraw and hoard notes in preference. In reality, if the public becomes uneasy as to the security of their deposits, no deposit rate, however high, would be sufficient to prevent a run. In both France and the United States the depositors are of extremely nervous disposition, and are easily frightened into withdrawing their deposits, even if there is no adequate reason for doing so. There is no justification for assuming that higher deposit rates would have in any way prevented the run which occurred in both countries towards the end of September and the beginning of October.

It seems unlikely that the increase of the note circulation in gold-using countries was in any way responsible for the rising trend of prices since the

end of September. The notes issued to meet deposits were promptly hoarded by the public, and the increase in the active note circulation was, therefore, more nominal than real. If depositors withdrew their funds from the banks because they considered it safer to keep them in the form of notes, they are not likely to spend any part of the funds withdrawn: and, if an increase in the note circulation does not lead to an increased demand for goods, there is no reason why it should lead to any rise of prices.

The principal motive of the deflationist policy adopted on the initiative of France was to prepare the defence of the gold standard against the inevitable adverse tendencies brought about by the suspension of the gold standard in a number of countries. The French authorities hoped that, by preventing a rise in their price levels, they might be able to avoid an increase in their trade deficit. There is no reason, however, to believe that these defensive measures are likely to succeed in obtaining this end. The exchanges of countries which have abandoned the gold standard are likely to depreciate to a level where they can bring about an increase of exports and a decline of imports. Thus, no matter what is the price level in gold-using countries, the countries which have abandoned the gold standard are at an advantage

against them. Possibly the deflationist policy was meant to be a gesture to show that the principal gold-using countries were determined to do their utmost to maintain the gold standard even at the cost of heavy sacrifices to their industries.

Time alone can tell whether the deflationist policy will be able in the long run to counteract the tendencies set into motion by the suspension of the gold standard in Great Britain. The Bank rate is far from all-powerful as a means to regulate prices, and there are many other factors at work which may vitiate the result. The most important of them is the German problem, which remains the key of the situation. Should the attempts to bring about a settlement of reparations and war debts result in a failure, the consequence would be a collapse in Germany, which again would necessarily aggravate the financial crisis and react unfavourably upon the economic situation. Such developments may easily check the improving trend brought about by Great Britain's departure from the gold standard, but this does not alter the fact that the effect of the change on the economic situation tended to be decidedly for the better.

Taking a long view, the suspension of the gold standard in Great Britain has brought the world relief, as it has resulted in a setback in the universal race for the adoption of gold currencies.

As we shall see in Chapter XVI, the simultaneous endeavours of practically all countries to establish gold currency would have resulted in a permanent excess of demand for gold over normal supplies and would have tended to bring about a persistent decline in world prices. The example of Great Britain has shown that there is no absolute necessity for every country to be on a gold basis. Even if the movement towards the universal adoption of gold is resumed after the restoration of normal trade conditions, it is not likely to be as excessive as it was during 1925–31.

CHAPTER XVI

STERLING *v.* GOLD

DURING the few years previous to the suspension of the gold standard it appeared as if all civilized and semi-civilized countries would adopt the gold standard before very long. Practically every country which was on a gold basis before the war returned to the gold standard, or adopted the gold exchange standard, between 1925 and 1930. Countries such as the members of the Latin Monetary Union, where silver coins played a subsidiary rôle before the war, demonetized silver completely. Most countries of Latin America which were on an inconvertible paper currency in pre-war days stabilized their currencies in relation to gold. Silver was being gradually abandoned by all countries of the East with the exception of China; and even the Chinese Government had decided in principle that it should adopt the gold standard as soon as possible. Although the system adopted by many countries on a gold basis was that of the gold exchange standard, this was generally re-

garded as a passing phase in the progress towards the universal adoption of the gold standard. There was reason to expect, therefore, that within the next decade or so a complete uniformity of the monetary systems would be established.

This tendency suffered a severe setback, if not a complete reverse, through Great Britain's departure from gold. As soon as her decision became known it was expected that a number of countries would follow her example. In fact, certain quarters in Paris were inclined to attribute to the British authorities the intention of deliberately wrecking the system—an assumption which is too absurd to be discussed seriously. In other quarters it was believed that, as Great Britain has lost the lead among the gold-using countries, she aimed at forming a group of countries which would adopt sterling as a basis for their currencies. In actual fact, as we pointed out in previous chapters, the suspension of the gold standard was the result of the force of circumstances, and not of any deliberate planning. This, however, does not exclude the possibility that its effect might be the creation of a group of countries on a sterling basis.

We have seen in Chapter XIII that a number of countries considered it desirable from a purely commercial point of view to allow a depreciation

of their currencies to the same extent as that of sterling. This does not mean that they deliberately abandoned the gold standard in order to safeguard the interests of their export trade. As it was obvious that the contraction of their British market would eventually force them off the gold standard in any case, they preferred to abandon the gold standard rather than to use up their resources in vain attempts to bolster up an untenable position. Thus, within a few days of the suspension of the British gold standard, the three Scandinavian countries followed suit. Their currencies were quoted for some time at a premium against sterling, but by the middle of October they were around their old parities. The Finnish mark followed the Scandinavian currencies after a few weeks of vain attempts to maintain its stability. Thus, practically the whole of Northern Europe showed its willingness to link its currencies with sterling. The Portuguese escudo remained stabilized in relation to sterling; it would have been indeed futile to try to maintain its stability in relation to gold, as the bulk of Portugal's export trade gravitates towards Great Britain. In December, Japan suspended the gold standard, and the yen depreciated approximately to the level of sterling. There is reason to believe that, before very long, several other countries will join the group.

As far as the British Empire is concerned, the adjustment to the new level of sterling has not been altogether unanimous. For political considerations the Union of South Africa has put up a desperate fight to remain on a gold basis as a demonstration of the centrifugal tendencies of that dominion. It is doubtful whether these efforts will prove successful in the long run, considering that the United Kingdom is the principal customer for South African products. The Canadian dollar has been oscillating somewhere half-way between the pound and the United States dollar. For considerations of prestige the Dominion Government has been unwilling to admit that its currency has lost touch with gold. The Australian pound has been for some time past at a discount of some 30 per cent. in relation to sterling. It was expected that, following upon the depreciation of sterling, the discount of the Australian pound might be reduced. There is reason to believe that the next few years will witness a *rapprochement* between the Dominions and the Mother Country in an economic and financial sphere. This *rapprochement* will manifest itself in the preferential treatment of Empire products, and also in the elaboration of some kind of uniformity in the monetary systems of the Empire. This, together with the increase in the number of countries in Europe and other con-

tinents which desire to link the fate of their currencies with sterling, will create an important group of currencies on a sterling basis.

The departure of this group of countries from gold cannot be regarded as definite. As we shall try to prove in the next chapter, the suspension of the gold standard in Great Britain is a temporary phase, although its duration will be longer than most people believe. During that period the currencies of the members of the group are likely to move in sympathy with sterling even if no official link is established between them. It is possible, however, that the Governments of the countries concerned may come to an understanding to collaborate sufficiently to stabilize the currencies of the group in relation to sterling. The result would be the development of a feeling of economic solidarity between those countries, and this, together with the convenience of stabilized exchange rates, would encourage trade between them. As they constitute a most important market for both agricultural products and manufactures, this would provide a strong temptation for other countries to join the group.

While the departure of the sterling group of currencies from gold ought to be regarded as temporary, the setback in the process of the adoption of gold as a universal currency is more likely

to prove permanent. As far as the silver-using countries are concerned, there is no doubt about it that in consequence of the gold crisis silver has received a new lease of life. Even if the dreams of those who hope to see the return to bimetallism will never materialize, there is no doubt that recent events will induce several Governments to reverse their decision to demonetize silver. There is no likelihood of China adopting the gold standard during the lifetime of the present generation. Mexico seems to have returned to silver, and it is doubtful whether she will attempt to return to gold for some time to come. Persia and Abyssinia, which were on the point of linking their currencies to gold, have postponed the definite change.

The movement to replace inconvertible paper currencies by gold currencies in Latin America and elsewhere has also suffered a setback. Economic and political conditions in many Latin American countries were not sufficiently settled to justify attempts at stabilization, and the efforts to bring them on to a gold basis were rather premature. It is more than probable that these efforts will not be resumed for some time to come.

Thus, the suspension of the gold standard in Great Britain resulted in the creation of four groups of monetary systems :

(1) Currencies on a gold or gold exchange basis.
(2) Currencies on a sterling basis.
(3) Currencies on a silver basis.
(4) Unattached currencies.

Many people may regret this setback in the movement towards uniformity, which in theory is undoubtedly the ideal state of affairs. In reality, however, this reverse was a blessing in disguise. The movement towards the adoption of gold as a universal basis for currency systems should be a gradual one. The simultaneous effort of the whole civilized and semi-civilized world to link its currencies with gold would inevitably lead to a scarcity of gold supplies in the face of persistent demands. This again would mean a continuous tendency for prices to decline, and a prolonged period of trade depression.

CHAPTER XVII

FUTURE OF THE GOLD STANDARD

When on September 21 the suspension of the gold standard was announced, a large section of public opinion and a number of prominent experts believed that it meant the definite abandonment of the system not only in Great Britain but all over the world. It was taken for granted that sooner or later every country would be forced by circumstances to follow Great Britain's example. For a short while it seemed as if this assumption were to prove correct, but before very long it was realized that a number of countries were determined to remain on a gold basis, and that they were in a position to carry out their decision. Thus the hopes or fears—whichever was the case—of a universal abandonment of the gold standard proved to be unfounded.

It seems also that the rejoicings of those who believed that Great Britain had permanently severed her connection with gold were also premature. In official quarters the present state of affairs is con-

sidered as essentially temporary, and the declared aim of the official policy is to stabilize sterling in relation to gold as soon as this is possible. Those who jumped to the conclusion in September that the events of 1931 meant the doom of the gold standard and the dethronement of gold appear to have completely misunderstood the situation. The wish being father to the thought, they imagined that the principal holders of gold stocks were becoming increasingly worried as to the fate of the wealth invested in their gold hoards. In reality, however, the possession of gold has never in modern history been valued to the same extent as it was during the financial crisis of 1931. As a result of the depreciation of sterling, complete uncertainty prevailed for some time as to the fate of every currency. Nobody knew whether even dollars, French francs, or Swiss francs with their note cover of 160 per cent, would not eventually succumb to the international pressure. Everybody distrusted everybody else's currency, and indeed no one had too much confidence in his own. At the same time, as we have seen in previous chapters, there was in most countries a wave of distrust in the banks, including the leading institutions which in the past had been considered to be above suspicion. In such circumstances "back to gold" was the slogan adopted by everybody, individuals

and nations alike. Central banks hastened to repatriate their dollar balances in the form of gold. Individuals endeavoured to convert their bank deposits and other possessions into gold coins and bars. It looked indeed as if the suspension of the gold standard in Great Britain had meant the beginning and not the end of the cult of gold-worship.

Doubtless, this violent wave of distrust is bound to be temporary. Sooner or later confidence in banks and in currencies will be restored, and gold hoarded by individuals and by nations will leave its hiding places. But the process will be a slow one. It will be long before the public abroad will trust its banks to the same extent as it did before the crisis of 1931. In this respect Great Britain is at a considerable advantage, for her depositors trusted her banks implicitly throughout the crisis. In practically every other country, however, it will take years before confidence is fully restored. The process of restoring faith in the stability of currencies will presumably be even longer. Those who believed that international monetary stability, which appeared to have been restored almost completely between 1925 and 1930, was of a permanent character, have been severely disappointed by the events of 1931, and it will be long before they trust the appearance of international stability once

more. The habit of hoarding gold is likely to increase rather than decrease in the near future, and it is hardly likely to decline to its pre-war level, or even to the level to which it declined during the period of post-war stability, in the lifetime of the present generation.

The wave of violent distrust will give way to a prolonged period of settled suspicion which will not be confined to individuals. Banks in many countries have adopted the habit of keeping gold stocks of their own, and, unless they are forced, either by legislation or by pressure on the part of the authorities, to surrender their hoards, they are likely to continue the practice. Nor will central banks easily forget the lesson of 1931. Their losses on their sterling balances have resulted in the complete failure of the movement for the adoption of the gold exchange standard. Central banks have realized that the advantage of earning interest on their foreign exchange holdings does not compensate them for the risk involved. In future they will aim at repatriating their reserves in the form of gold. If the surplus is of an obviously temporary nature, possibly they may be willing to make arrangements for leaving it in the form of gold deposits in other centres, but there is no likelihood of any central bank maintaining large foreign exchange reserves for any length of time.

The suggestion has been made that the gold exchange standard could, after all, be saved by the adoption of a method whereby the gold value of the foreign exchange reserves of central banks would be guaranteed by the central bank with which they are deposited or by the Bank for International Settlements. It is difficult to see, however, how the system could operate in practice. In many cases central banks desirous of obtaining external support would be prepared to guarantee the exchange rate of the deposits of other central banks, but financially stronger countries which are lenders rather than borrowers have no advantage in attracting foreign central bank deposits on such conditions. The experience of 1931 has proved that the presence of large amounts of foreign short-term deposits is a doubtful blessing for any centre. The monetary authorities of the leading financial centres are not likely, therefore, to go out of their way to attract such balances. As central banks will be far from anxious to keep their balances in weak centres even if they are secured by exchange guarantee, the refusal of strong centres to give them such a guarantee leaves them only one alternative, and that is the repatriation of their surplus in the form of gold. The suggestion that the Bank for International Settlements may accept deposits and guarantee the exchange rate is also impractic-

able, owing to the fact that that institution has no gold reserve of its own, and also because of the difficulties in the way of covering the exchange risk involved in such guarantees by means of forward exchange transactions.

Possibly the development of an active forward exchange market might overcome the difficulties, as it would enable central banks to keep deposits abroad without running any risk from exchange depreciation, but it will be a long time before confidence in international banking is sufficiently restored to make the development of a really active forward exchange market possible. The transfer of the gold surplus of central banks to the Bank for International Settlements would enable the latter to solve the problem, but in prevailing circumstances there is little hope of inducing the leading central banks to part with their surplus gold. The ideal of a huge international gold reserve will, therefore, remain a Utopian dream for some time to come.

In such circumstances it may well be asked how the adherents of a system of managed inconvertible currency imagine that they could eliminate the need for the use of gold. In an ideal world where everybody trusted everybody else, their plan would be undoubtedly practicable, but, amidst the general distrust brought forth by the crisis of 1931, gold is

more sought after than it has ever been since the development of modern finance. If a country has a surplus of visible and invisible exports over visible and invisible imports, this surplus can be dealt with in one of four ways. It can be repatriated in the form of additional imports ; it can be re-lent abroad in the form of long-term loans ; it can be left abroad in the form of short-term deposits ; or it can be repatriated in the form of gold. Owing to the increasing protectionist tendencies all over the world, the repatriation of a surplus in the form of commodities is not likely to be encouraged. As a result of the wholesale default by debtors in every part of the world, investors will hesitate before they take up any new foreign loans for some time to come. As for the practice of leaving the surplus abroad in the form of short-term deposits, we have seen above that it involves considerable difficulties. The only remaining alternative is to repatriate the surplus in the form of gold. Thus, whether or not gold will play any part in the internal monetary system, it is bound to play a prominent part in the international financial system. It may be said that as a result of the crisis of 1931 the movement in favour of a currency system in which gold plays no part whatever has suffered a setback from which it is not likely to recover until after the complete restoration of confidence.

This does not, however, mean that the movement towards a universal adoption of the gold standard will be resumed as soon as the present crisis is over. As we said in the last chapter, that tendency suffered a reverse through Great Britain's departure from gold. Even if it is resumed sooner or later, it will be a gradual process. Meanwhile, gold will continue to play a predominant part in the settlement of international balances, and will be used for the accumulation of external reserves by central banks, whether or not they are on a gold basis. Possibly, the result of the present crisis will be the evolution of a new conception of the gold standard, according to which gold will continue to fulfil the international functions to which it is eminently suited, but the value of the currencies will not be rigidly pegged to gold.

Another highly controversial question is whether the experience of 1931 will lead to the remonetization of silver through the adoption of bimetallism by a number of countries. An increase in the monetary use of silver is undoubtedly highly desirable, as it would contribute towards international economic recovery. An appreciation of silver through its remonetization would increase the purchasing power of about half the world's population. A number of schemes have been put forward to that end, but all of them presuppose a

general agreement between the principal gold-using countries. So long as some of the leading countries desire to remain on a purely gold basis, other countries adopting bimetallism would run the risk of becoming the dumping ground for surplus stocks of silver. Even if bimetallism were to be adopted generally, there are grave doubts as to whether the system would be practicable in face of excessive production. Should silver be remonetized even as a subsidiary coin, as was the case with the Latin Monetary Union before the war, it would be necessary to take measures of precaution against an excessive increase of output. This might be achieved either by a general agreement between all producing interests to limit their output or by fixing the value of silver in relation to gold sufficiently low to make an increase of production unprofitable. The first alternative is to be preferred, as silver is often the by-product of other metals, and its production may, therefore, increase even if its price is stabilized at a low figure.

Doubtless the remonetization of silver would be a somewhat risky experiment even if co-operation between all gold-using countries and all silver-producing interests could be achieved. In spite of this, it would be desirable to take the risk involved. Otherwise the gold-using countries will continue to suffer from the effects of a gold shortage.

As a result of distrust and resultant gold hoarding, the supply of gold relative to the demand may further decline, which again may tend to bring about a prolonged decline in prices. To avoid this, it would be worth while taking the risk of experimenting with the partial remonetization of silver.

CHAPTER XVIII

FUTURE OF THE POUND

WHEN the gold standard was suspended, many people, as we observed before, regarded it as a permanent departure from gold, but others went to the opposite extreme in considering it as a purely temporary measure which would soon be followed by stabilization at a lower level. The latter imagined that once sterling had declined to a level at which the cost of production in Great Britain could become competitive with that in other countries, the exchange would be stabilized at once. The favourite figure at which sterling was expected to be stabilized was originally about four dollars. It was taken for granted that the official monetary policy aimed at stabilizing as soon as possible and at as high a level as possible. When in October sterling showed signs of recovery, and, after having dropped down to about \$3·50, was beginning to approach \$4, it was believed in many quarters that stabilization was only a question of weeks. The view was widely held that, as soon as the

General Election was over, the National Government would take a definite decision as to the rate and date of stabilization. When the Election was over, however, sterling began to decline instead of continuing to rise as it was expected to do as a result of the Government's victory.

There are several reasons for this unexpected relapse. In the first place, the appreciation of sterling during the greater part of October was largely due to uncertainty as to the fate of the dollar, as a result of which many British and foreign holders of dollars transferred their funds to London. As towards the end of October fears in this respect were allayed by the conclusion of an agreement between the French and American monetary authorities, the return of confidence in dollars reversed this tendency. Moreover, during October many importers refrained from covering their requirements of foreign exchanges, as they hoped that in consequence of a Government victory, sterling would move in their favour. These requirements had to be covered in great haste between the end of October and the beginning of November. In addition, the anticipation of a tariff in consequence of the Government's victory resulted in a heavy inflow of manufactured articles, which contributed to increase the pressure upon sterling. As a result of all these adverse factors sterling

depreciated to the vicinity of \$3·25 early in December.

Those who hoped that the Government's victory would be followed by immediate stabilization were disappointed. In his speech delivered at the Lord Mayor's Banquet at the Guildhall, the Prime Minister stated that sterling would be stabilized as soon as possible, but not until the improvement of the situation both internal and international justified such a step. This ruled out the possibility of stabilization within the ensuing few months, for even extreme optimists could not expect the situation to improve fundamentally in the immediate future. The situation may be compared with that of 1914, when many people expected a short and stiff campaign of three months, while the authorities considered it necessary to prepare for a prolonged war of several years.

As the question of the date of stabilization is likely to be the centre of heated controversy for some time, we propose to give below the principal arguments for and against an early stabilization. The following are the main points in favour of stabilization at an early date:

(1) Prolonged fluctuations of sterling are detrimental to our export trade. As at present the major part of our export trade is transacted in terms of foreign currencies, holders are finding difficulty

in covering the exchange risk, and are seriously handicapped by uncertainty as to the future of sterling. This is particularly damaging where long-term contracts are concerned. If a shipbuilding firm, for instance, has to quote prices in francs or guilders for payment, say, two years ahead, it has to reckon with the risk of an appreciation of sterling in terms of those currencies. The difficulties of this state of affairs should not, however, be exaggerated. After all, if the depreciation of sterling is, say, 25 per cent, exporters are in a position to quote considerably lower prices than they could have before September 21. Even if they allow for the risk of a partial recovery of sterling, they are still at a considerable advantage. After all, nobody expects a return of sterling to its old parity, and very few people expect it to rise above \$4. Thus in allowing for a possible appreciation of sterling of, say, 10 per cent, exporters are still in a position to quote prices 20 per cent under their old level.

(2) The daily fluctuations of sterling and the uncertainty as to its definite level of stabilization have introduced the gambling element into everyday business transactions with foreign countries. Owing to the difficulty of covering forward exchanges, both importers and exporters are compelled to gamble in the exchanges, very much

against their wish. This is unquestionably an unfavourable state of affairs, but with the improvement of conditions in the forward exchange market, it could be gradually remedied even if sterling is not stabilized in the near future.

(3) Prolonged fluctuations of sterling are detrimental to London's position as an international banking centre. So long as no adequate facilities are available for covering forward exchange, foreign banks and business firms will be reluctant to avail themselves of acceptance credit facilities in London. They will be equally reluctant to keep sterling balances above their immediate requirements. International trade will adopt the dollar or the French franc in the place of sterling as an international means of payment. If stability is restored before long, London may regain her old position, but, if the period of instability is prolonged, other centres may develop the technical facilities which they do not at present possess, and London will find it more difficult to reconquer the lost ground. All this is unquestionably true, but a premature stabilization would not be a remedy, as it would not create a feeling of certainty as to the prospects of sterling.

(4) Prolonged instability would be detrimental to London's international insurance business. So long as sterling fluctuates, foreigners are re-

luctant to take out policies in terms of sterling even for a short period, and still less for long periods. As in the case of international banking, a prolonged period of uncertainty may lead to the development of rival facilities in other centres. The remedy lies in the development of facilities for covering the exchange risk for longer periods.

(5) The possession of an unstable currency is regarded as detrimental to the political and financial prestige of Great Britain. While after the war every currency, with the exception of the dollar, was fluctuating, at present there is a comparatively large number of stable currencies left, and this fact places Great Britain in an inferior position. The sooner this can be remedied the better. But here again it may be asked how far stabilization would eliminate the feeling of uncertainty which, after all, is almost as detrimental to British prestige as the actual fluctuations themselves.

The following are the main arguments against an early stabilization of sterling :

(1) It will take some time before it can be ascertained at what level sterling should be valued so as to restore the equilibrium of the British trade balance. It is impossible to judge the effect of the depreciation of sterling upon imports and exports on the basis of the experience of a few

months. Much depends upon the tariff policy of this country and that of other countries.

(2) So long as there is a possibility that the process of deflation may continue in the countries on a gold basis, it would be unwise to link sterling once more to gold. Great Britain has suffered a great deal during the last ten years through deflation, and no responsible statesman would deliberately expose the country to further sufferings on that account. So long as world prices do not attain comparative stability, it is desirable to maintain sterling's independence of gold currencies. If we have to choose between the evils of fluctuating prices and those of fluctuating exchanges, the latter are undoubtedly the lesser of the two.

(3) So long as the international monetary situation remains uncertain, it would be a mistake to stabilize sterling. While there is a possibility that rival countries, such as Germany, may come off the gold standard, British trade may be placed at a disadvantage if sterling is stabilized.

(4) It is not advisable to stabilize sterling until after the definite settlement of the problem of reparations and war debts. So long as the disturbing influences of excessive political debts are not eliminated, the basis of stability would be uncertain.

(5) Since in connection with the support of

sterling during the summer of 1931 the British authorities contracted external liabilities to the amount of £130,000,000—of which £110,000,000 is still outstanding—it is desirable to postpone stabilization until the authorities have acquired a sufficient amount of foreign currencies to meet these liabilities. Otherwise the necessity for finding the foreign exchange required for repayment would cause a strong and persistent pressure on sterling. It is true that there is a possibility of consolidating these short-term debts after the return to more normal conditions, but this course should be avoided if possible.

(6) Experience has proved that the gold stock of the Bank of England was inadequate to cover requirements. It is not advisable for Great Britain to return to the gold standard until the Bank of England has succeeded in accumulating a gold and foreign exchange reserve of at least £200,000,000 after the deduction of the amounts required for the repayment of external short-term debts, including the sterling balances of foreign central banks. This may take place either through the creation of an export surplus, or through the mobilization of some of the British foreign investments. In either case the process must be of long duration.

Without minimizing the importance of the argu-

ments in favour of an early stabilization, we believe that the weight of argument is overwhelmingly against premature measures. It would be a mistake for Great Britain to stabilize until she can do so without running any undue risk. Should it become necessary, as a result of premature stabilization, to abandon the gold standard once more, it would be a fatal blow to the prestige of the country, and would affect London's international financial position to a much greater extent than a prolonged period of instability.

Let us now examine the question of the rate at which sterling should be stabilized. At this stage it would be premature to form any definite opinion. It is desirable, nevertheless, that the authorities should adopt a definite policy as to fundamental principles, subject to modifications according to the development of the internal and international situation. The following are the arguments in favour of stabilizing sterling at the highest possible level :

(1) If the extent of the depreciation of sterling is only 20 per cent or so, it may be possible to avoid an increase in wages. Producers and exporters would, therefore, benefit by the full extent of the depreciation of sterling. Should the depreciation assume wider dimensions, a rise in

the cost of living would render an increase in wages inevitable. This argument is hardly convincing, as in case of a depreciation of sterling beyond 20 to 25 per cent, the additional bounty on exports will enable producers to pay higher nominal wages, provided that the extent of their increase remains smaller than that of the depreciation of sterling.

(2) The increase in the cost of living in case of a substantial depreciation of sterling would reduce the purchasing power of fixed incomes, and would affect adversely large classes of the population. This is unquestionably true, but it ought to be borne in mind that one of the chief obstacles to a trade revival in Great Britain since the war has been the excessive burden of unearned incomes which the productive classes have had to bear. Ever since 1920 Great Britain, with her steadily declining prices, has been a *rentier's* paradise. It is necessary in the interests of the country's prosperity to reverse this state of affairs. The choice lies between sacrificing the interests of productive or unproductive classes.

(3) As Great Britain possesses a large amount of foreign investments, the depreciation of sterling tends to bring about a reduction in their gold value. Undoubtedly this constitutes a serious loss to national wealth and national income, but the

extent of these losses should not be exaggerated. The amount invested in ordinary shares abroad will not be affected by any depreciation of sterling. A large part of the foreign bonds acquired by Great Britain contains a currency clause which enables holders to obtain interest and redemption in terms of a gold currency. In the case of debentures of South American railway companies and other enterprises, the greater part of the ordinary share capital is held also in Great Britain, so that holders of ordinary shares will benefit to the same extent as holders of debentures will lose. From the point of view of national wealth and income this does not, therefore, represent a loss. Notwithstanding all this, the amount of the loss will be considerable, supposing that the depreciation of sterling assumes greater dimensions. It ought to be borne in mind, however, that, in proportion as Great Britain loses on these investments, the burden of debtor countries may be relieved. They will thus be in a better position to meet their liabilities and to buy British goods, and this result will compensate Great Britain to some extent for the loss.

(4) From a moral point of view it is desirable that sterling should be stabilized at the highest possible level so as to reduce to a minimum the losses of foreign holders of sterling balances and of

sterling securities. This is undoubtedly a serious consideration. It is true that the French example created a precedent for sacrificing foreign creditors for the sake of national considerations, but it is important and desirable that Great Britain should maintain her moral superiority, and should do her utmost to safeguard the interests of those who trusted her currency. This does not mean, however, that the authorities should stabilize sterling at an unduly high level. If the rate chosen is too high a situation may arise which may make it necessary to abandon the gold standard once more and to allow sterling to decline to its natural level. This would inflict additional losses on either the same holders of sterling or a new set of foreign holders, and this should be avoided. Thus sterling should be stabilized as high as is possible without having to take the risk of being unable to maintain it at that level.

The following are the principal arguments in favour of stabilizing sterling at a lower level :

(1) The level chosen should be sufficiently low to secure a favourable trade balance during the period of readjustment and thus to provide a natural support for sterling until confidence in its stability is restored. This is what happened in France in 1926.

(2) The level chosen should be sufficiently low

to bring about a reduction in the real burden of the public debt. This can only be achieved after sterling depreciates to a sufficient extent to bring about a rise in wages and other incomes, as a result of which it would be possible to reduce the rate of income tax. Otherwise it would be necessary to maintain income tax between 4*s.* and 5*s.* in the £ for a prolonged period, which would discourage the repatriation of capital that took flight abroad.

(3) The rate chosen should be sufficiently low to eliminate any doubt as to the likelihood of stability being abandoned once more. It is to be feared that a rate of \$4 to the £ would not command more confidence than did the rate of \$4·86, for it would not bring about a sufficient accumulation of reserves to support sterling and it would not reduce the burden of the public debt appreciably.

For these reasons it is desirable to fix the rate of stabilization at a relatively low level. There is, of course, no question of suggesting any deliberate depreciation of sterling so as to take advantage of its beneficial effects. All that is required is to allow sterling to decline to a level where it can safely be maintained, and where it commands confidence. It would be a fatal mistake to attempt to bolster it up artificially, and to stabilize it too

high. Everybody agrees that it was a mistake to stabilize sterling too high in 1925. A second mistake of the same nature, while the memories of the first are still fresh, would be unpardonable.

CHAPTER XIX

POLITICAL ASPECTS

We have pointed out in Chapter I that the fall of sterling fulfilled a historical part, as it provided a timely warning to the British nation, and aroused it from its apathy. There had indeed been every indication since the war that the British Empire was heading towards decline. The post-war economic and political situation of Great Britain disclosed a certain similarity to the situation of the Roman Empire when its decline was beginning. The accumulation of wealth and power, coupled with a democratic political system, resulted in the growth of large unproductive classes, and, as in Rome, there was an increasing number of idlers both in the upper and lower ranks of society. The pre-war accumulation of huge overseas investments together with the creation of immense fictitious wealth during the war, resulted in a large increase in the number of those who lived on the yield of deadweight capital without playing their part in productive activity, and slackened the ambition

of those who continued to do productive work. The number of idlers in the upper classes and middle classes rose to hundreds of thousands. They filled continental seaside resorts and British golf courses.

With the development of a democratic parliamentary system, and the abuses that inevitably accompany it, idleness ceased to be a class privilege. There appeared to be plenty of money in the till, and, human nature being what it is, it was hardly surprising that the working-class millions were tempted to use their newly-acquired political power for helping themselves to it. The political parties were outbidding each other in their attempts to bribe the electorate. The introduction of the system of unemployment relief and its abuses, which were tolerated by all post-war Governments irrespective of party, resulted in the development of a huge class of professional idlers among the working classes.

Post-war Britain, with its hundreds of thousands of idle rich and its millions of idle poor, presented a deplorable picture of decay and decline. This was the inevitable consequence of the fundamental laws that govern human nature. Throughout history a nation which has become wealthy has inevitably lost its energy, ambition, and desire for work, and has tended inevitably to decline.

For over a century the splendid qualities of the British character successfully resisted this tendency, but the demoralizing effects of the war weakened its resisting capacity. The signs of decline in Great Britain were admirably described by André Siegfried in his book, *England's Crisis.* With a clarity characteristic of the French, he pointed out the weak spots in the British political, economic and social system, with all their adverse consequences. And, with the rhetoric characteristic of the French, he uttered the warning, "England, awake!" But England showed no inclination to awake. In fact, as is often the case when people are disturbed in pleasant dreams, she strongly resented the attempt to awaken her. M. Siegfried's critics spared no effort to find fault with his arguments. They revelled in discovering inaccuracies of detail and exaggerations, and sought to conceal the fundamental truth of his thesis by attacking him on trivialities. It was indeed unlikely that a nation should be aroused merely as a result of the exhortations of an economist. Few people, if any, were inclined to pay heed to it. As is usually the case when someone tries to be impartial, M. Siegfried succeeded in offending everybody, Conservatives, Liberals and Socialists alike. Although Conservatives were pleased with his criticism of the dole and of Free Trade, their narrow patriotism

resented criticism of Great Britain by a foreign economist. The narrow doctrinairism of Liberals, on the other hand, resented the doubt cast upon the belief that in a country on a Free Trade basis everything is bound to turn out satisfactorily in the long run through the natural working of economic tendencies. As for the Socialists, in their narrow policy of class-above-nation, they could not forgive him for criticizing Trades Unions, high wages and the dole. The nation was obviously in need of a much more severe warning than could be embodied in any book. In the depreciation of sterling through the suspension of the gold standard this much-needed warning was forthcoming.

But for the shock administered to the public conscience by the depreciation of sterling, it is highly probable that the post-war tendencies, which pointed towards an economic and political decline of the British Empire, would have continued. Production in Great Britain was obviously not on a competitive basis. The foreign rivals of British manufacturers were capturing one market after another, and were even penetrating to an increasing extent into the home market. Even the optimistic statistics of the Board of Trade had to admit that the surplus of visible and invisible exports over visible and invisible imports was reduced considerably during 1930. In any other

country this fact in itself would have aroused grave concern, and would have induced the interests concerned to take action for remedying the evil by enforcing a reduction of wages or an increase in working hours. In Great Britain, however, thanks to the penetration of Free Trade doctrine in the national mentality, the warning of the trade balance was disregarded. A considerable section of public opinion was convinced that the trade balance could look after itself, and that the trade deficit was bound to set into motion factors which carry its corrective. In theory they were unquestionably right. In practice, however, the rigidity of wages through the political power of the Trades Unions and the dole system, vitiated the working of natural economic tendencies. The trade balance would automatically correct itself if wages in trades suffering from depression were to decline, or if sterling were allowed to depreciate so as to encourage exports and check imports; but so long as wages are kept up artificially, and so long as sterling is maintained stable, these tendencies cannot work.

The importance of the British Empire as a first-rate power in international politics would have declined gradually but for the effect of the suspension of the gold standard. London's inability to lend abroad would in itself have reduced the

political prestige and power of Great Britain. The budgetary situation and the excessive burden of public debt would have made the British Government incapable of asserting itself in international conflicts, or even of defending various parts of the Empire. With income tax between four and five shillings in the pound, and with the public debt at seven and a half milliards of gold pounds, Great Britain simply could not afford to undertake another war. To all intents and purposes she has therefore been disarmed in a world armed to the teeth. Foreign powers and centrifugal elements in the Empire itself have been fully aware of this, and have taken full advantage of it. Pacifists may say that this is a highly desirable state of affairs. Undoubtedly it is, provided that every other country is in the same position, but so long as Great Britain is at a disadvantage in this respect, it does not in any way further the cause of pacifism. In fact, it prevents Great Britain from making herself felt in the interests of international peace. Her signature on pacts of non-aggression is of doubtful value if she is prevented by financial considerations from co-operating in a war against a disturber of international peace. Doubtless, had Britain to defend herself against aggression, she would not have hesitated to abandon the stability of sterling and to fight even if it meant financial

ruin. But apart from this most unlikely contingency, excessive taxation and excessive public debt have reduced the Army and Navy to mere ornaments, and have seriously reduced the political influence of Great Britain abroad. This process of decline would have continued as a result of a further deterioration of the country's trade and finances. It is possible and even probable that the autonomist movements in various parts of the Empire would have had to be allowed to take their course simply because the motherland could not have afforded to fight to retain what she possessed. Thus it is no exaggeration to say that, had the stability of sterling been maintained in spite of the adverse fundamental trend, it might have led to a disintegration of the British Empire.

What is even more important than any of the above considerations is the effect of the developments upon the greatest of all the national assets, the British character. Industrial and financial supremacy, external reserves, political power can be lost and regained. But the loss of the qualities of the British character which have built and maintained the Empire would have been irretrievable. As we pointed out at the beginning of this chapter, the demoralizing effects of the war left their trace on the character of the British nation. But for a strong and emphatic warning, the pro-

cess of moral deterioration would have continued. The warning would have come sooner or later, but perhaps it would have been too late. The changes were coming too surreptitiously to awaken the nation from its apathy. Sterling would have remained stable, although the qualities symbolized by its stability would have ceased to exist. Under the smooth surface of a stable exchange, the process of decay would have been allowed to continue.

So far we have dealt only with the political aspects of the suspension of the gold standard from the British point of view. Let us now examine it from an international point of view. The two cannot be separated by any rigid line of demarcation, for the political strength and prestige of the British Empire is one of the fundamental forces in international politics working towards the maintenance of order and peace. The decline of Great Britain would have meant the weakening of pacifistic tendencies, and the elimination of the main factor that works towards maintaining political equilibrium by counteracting the aggressive and imperialistic tendencies of other nations. If internal decay and the decline of external prestige were to prevent Great Britain from fulfilling her historical mission, this would have a fatal effect upon international peace. We need not go far afield to find an example to illustrate this. Great Britain

is at present practically the only obstacle in the way of the aggressive French ambitions for domination over Europe. But for the independent policy pursued by Great Britain, Germany would be at the mercy of French imperialism. Driven to despair, the German nation might resort to opposing France by armed force, which would result in an international conflagration similar to that of 1914. It is the task of Great Britain to prevent this by pursuing her historical rôle of maintaining the balance of power.

As we have seen in an earlier chapter, the gold standard was maintained during the summer of 1931 with the aid of French credits. France was prepared to continue to support sterling provided that Downing Street was prepared to yield to the influence of the Quai d'Orsay in matters of foreign policy. To maintain sterling at such a cost would have been fatal from the point of view of the nation's prestige and self-respect. A great nation that is prepared to sell its dignity for financial support must be well on its way towards decline. While the effect of the depreciation of sterling upon British prestige may be eradicated by the restoration of stability, nothing could ever have eradicated from the history of the nation a humiliating bargain such as French support on the French terms would have implied.

The suspension of the gold standard has checked the process of decline both from an internal and from an international political point of view. Internally the result of the General Election showed that the nation has understood the warning of the depreciating pound, and cast aside party and class interests in order to support the Government which stands the best chance of restoring stability. Internationally the departure from gold has obviated the necessity of depending upon French support, which would have paralysed Great Britain's freedom of action in the sphere of international politics. Although at this stage it would be premature to pronounce any definite judgment upon the effects of the change, there is reason to hope that it will result in national revival of a lasting character, such as was experienced in Italy from the advent of the Fascist régime.

CHAPTER XX

CONCLUSION

We live in a period of dramatic developments and of kaleidoscopic changes of situation, and in such times it is a thankless task to forecast the future. By the time a writer's conclusions appear in print they may have been already rendered obsolete by events. Notwithstanding this, we feel that we run no grave risk in concluding that, taking a long view, the departure of Great Britain from the gold standard will prove to be beneficial both from a British and an international point of view. We do not attempt to minimize the grave immediate inconveniences caused by the depreciation of sterling. Beyond doubt, it has aggravated the international crisis, and has inflicted heavy losses upon many countries. It has undermined confidence in the monetary and banking system of most nations. We believe, however, that the result in the long run will prove to be worth the price paid for it.

From a British point of view the depreciation

of sterling came as a timely warning which checked the political, economic, financial and moral decline of the nation. We have dealt with the political and moral aspects of the change in Chapter XIX; here we shall confine ourselves to attempting to appreciate its economic and financial significance.

Had the stability of sterling been maintained, the chances are that Great Britain's trade balance would have closed with a large and increasing deficit year after year. While in the past the deficit of visible trade was more than compensated by a surplus of invisible exports, the world crisis brought about a considerable reduction in the latter. The proceeds of shipping, insurance and banking have fallen off, while the yield of foreign investments has declined through the depression in business conditions abroad and through the actual default of a number of foreign debtors. Part of this decline may be temporary, but it is reasonable to assume that a fairly considerable part of it is permanent. Even without the world crisis British invisible exports would have declined, though perhaps not to the same extent. Shipping charges were excessive as compared with those of other countries, while foreign centres developed banking and insurance facilities of their own.

The proceeds of foreign investments had a declining trend through the emigration of capital

caused by high taxation. It is impossible to maintain direct taxation in any country at a considerably higher level than in other countries without bringing about such an emigration. Although the British nation has a higher standard of fiscal patriotism than any other nation, the increasing discrepancy between income tax and death duties in Great Britain and in foreign countries could not help tempting many capitalists to seek evasion of these charges by transferring their capital abroad. This process would have continued even if the world crisis had never developed, for owing to the heavy burden of the public debt and the unwillingness of Governments and Parliament to face the unpopularity of economies, there was no chance of any substantial reduction in taxation, while in most other countries the burden of taxes was being gradually reduced.

In such circumstances, the only way by which the stability of sterling could have been maintained in the long run was by drawing upon the external reserve of the country represented by its huge foreign investments. But for the world crisis it is this course which would have been adopted. In fact, for several years past this process has actually been going on. Important holdings of securities in South American public utility undertakings, the nitrate industry, the rubber industry,

etc., have been acquired by American interests. In the course of the next decade or so the most valuable part of the British portfolio of foreign securities would have thus been lost. As a result, invisible exports represented by the yield of foreign investments would have further declined, which again would have increased the annual amount that would have had to be met by selling out foreign investments. Moreover, as trade follows the trend of capital, the loss of certain securities would have brought about a decline in commodity exports, thereby accentuating the deficit of visible trade.

The contention of Free Traders that in the long run this adverse tendency would have brought its own corrective through the natural working of economic influences, is highly unconvincing. So long as the nation was unaware of its decline there was no likelihood of the elimination of the political obstacles to the working of those tendencies. The reduction of British foreign investments would have been too gradual and invisible to provide a strong enough warning. Wages would have continued to be kept at an uneconomic level thanks to the operation of the system of unemployment benefits. Sterling would have remained stable, and there is no reason why a trade deficit should not have remained a permanent feature of our trade balance for several

decades, so long as there was an external reserve to draw upon. Owing to the hold which the doctrine of Free Trade had upon the British nation, there was but little likelihood of a reduction of imports by artificial means. Thus, while internal trade would have been kept comparatively active through the spending power distributed to the recipients of unemployment benefits and to holders of Government securities, export trade would have declined gradually. Great Britain would have lost her industrial supremacy in the course of the next decade or two. She would also have lost her external reserve, which enabled her to maintain a high standard of living. A sudden loss would have awakened the nation's conscience, but the slow hæmorrhage would have passed practically unnoticed. So long as there was a reserve to draw upon it would have been practically impossible to enforce the unpopular measures required for remedying the situation.

London's financial supremacy would have also died a lingering death. For some years there was no considerable real surplus available for lending abroad, and in this respect the situation would have developed from bad to worse. Any attempt on the part of London bankers to retain their clientèle would have brought about overlending, and the result would have been an adverse

trend of the exchange and a loss of gold. This again would have necessitated maintaining the Bank rate at a high level. In any case, as the process of selling out foreign investments is necessarily of a spasmodic character, from time to time the pressure of an adverse trade balance upon the exchange would have in itself necessitated defensive measures such as a high Bank rate and an unofficial embargo on foreign lending. It is true that high interest rates in London would have tended to attract foreign capital, which again would have been available for lending abroad, but, as other financial centres would have been cheaper for borrowers, only those unable to borrow elsewhere would have been willing to pay the higher interest rates prevailing in London. Moreover, the increase of foreign investments in Great Britain, whether short-term or long-term, would have rendered sterling extremely vulnerable, and would have exposed it sooner or later to a collapse through heavy withdrawals, such as occurred in 1931, even if there had been no world crisis. In fact, confidence in the stability of sterling would have gradually declined, and the rate of interest, which would have been adequate to attract and retain foreign capital, would have had to be increased steadily. The burden of high interest rates would have provided a further handi-

cap to trade. Although in theory it should result in a reduction in prices, in practice the political factor would have prevented such a reduction, and the only result would have been an increase in unemployment.

The budgetary situation and Great Britain's credit would have also been undermined by this slow process of destruction. Direct taxation has reached the stage beyond which an increase in the rate cannot bring about any increase in its yield. The decline of revenue brought about by trade depression would have had to be met by Government borrowing. Year after year it would have been more difficult to balance the budget, and increased borrowing would have raised the rate on which the Government could meet its requirements. Undoubtedly, but for the world crisis the British Government would have continued to enjoy an almost unlimited credit both in the home market and abroad, especially in New York. It would have taken a long time before the stage was reached beyond which borrowing could not have continued. An annual deficit of some £25,000,000 to £30,000,000 would not have been in itself a sufficient shock to make the nation realize the situation so long as the stability of sterling was maintained by drawing upon external reserves or by external borrowing.

In the long run the stability of sterling could not have been maintained amidst all these adverse tendencies. Even without the crisis, the process of decay would have undermined its stability in the course of the next decade or so. It is of course possible that something would have happened sooner or later to arouse the nation. Possibly the loss of one of the most valued British colonial possessions might have produced the same effect as a warning as the depreciation of sterling. Possibly a leader of tremendous personality might have arisen, and would have carried the nation with him. Possibly some invention or discovery would have revealed a new source of immense wealth. But we cannot rely on the anticipation of windfalls or miracles. The balance of probability is that the process of deterioration would have continued until under the weight of adverse tendencies sterling would have eventually collapsed.

It was indeed a blessing in disguise that, as the collapse of sterling was inevitable, it took place in 1931 instead of 1941 or 1951. So far the process of decay has not reached a very advanced stage. It can easily be stopped once the nation realizes the necessity of facing facts.

In spite of the losses on foreign investments through default, depreciation of the securities, and the depreciation of sterling, they still represent

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a very considerable sum. Although at present they are immobilized as a result of the world crisis, in the long run they will continue an important item in the national wealth. As a result of the depreciation of sterling the lost markets may also be recovered, or, failing that, a larger part of the home market may be reserved for home production than has been the case up to now. Once the fiscal patriotism of the nation is aroused, it will be easy to place the country's public finances on a sound basis, and to stop the flight of capital from taxation.

From an international point of view, the significance of the suspension of the gold standard in Great Britain cannot be appreciated sufficiently. Whatever its immediate effects may be, in the long run it is bound to be beneficial both from a political and an economic point of view. We have seen in Chapter XVI that the simultaneous adoption of the gold standard by practically the whole world threatened to bring about a persistent demand for gold in excess of the supply for a period extending over many years to come. This would have meant a prolonged period of deflation and international trade depression. The world appeared to have become enslaved to the ideal of a sound and uniform currency system. Those experts who regarded it as the supreme

aim of policy to put every country in the Balkans, in Latin America and the Far East on a gold basis, overlooked the fact that sound currency should be only a means to an end, and not an end itself. If the supply of gold were adequate for every country to adopt the gold standard without bringing about an excessive fall in prices, the policy aiming at the uniformity of currency systems would undoubtedly have been justified. In practice, however, it caused a decline of prices which was bound to inflict depression, suffering and misery upon mankind.

Great Britain's departure from gold is hoped to break the spell. If a country which has always been regarded as an example of sound monetary principles departs from gold even temporarily, it shows that the possession of a currency based on gold is not a vital necessity for all countries from China to Peru.

It is true that, owing to the uncertainty caused by the depreciation of sterling, gold is likely to be in strong demand, and most countries will aim at the maintenance or restoration of the gold standard, though possibly in a modified form. The chances are that the movement will be spread over a longer period. For some years, the currencies of many countries are likely to remain inconvertible, and the adoption of the gold stan-

dard is likely to be a gradual process. Even if deflation were to continue as a result of the demand for gold, it will confine itself to the comparatively small number of countries whose currencies will remain on the gold standard. There is nothing to prevent a moderate trade recovery in countries which, for the time being, have detached their currencies from gold. As we have seen in Chapter XIX, the effect of Great Britain's departure from gold was to check the decline of the British Empire as a factor in international politics, and to safeguard the freedom of action of British foreign policy. Great Britain is thus once more in a position to assert herself in the interests of international equilibrium and peace. This result in itself was worth any sacrifice.

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